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CORPORATE LIQUIDATIONS AND THE "GENERAL UTILITIES RULE"

by

William H. Lyons*

SECTION 336(a) of the Internal Revenue Code of 1954¹ provides that, subject to certain exceptions,² a corporation does not recognize gain or loss when it distributes property to its shareholders in connection with the complete liquidation of the corporation.³ This nonrecognition rule first appeared in 1919 in the Treasury Regulations⁴ and continued as an administrative rule until it was codified in section 336(a) of the 1954 Code.⁵ Congress does not appear, however, to have pondered the rule's appropriateness. Although the rule has undergone significant legislative⁶ and judicial⁷ erosion since enactment, Congress has apparently

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1. I.R.C. § 336(a) (1982): "(a) *General Rule*.—Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation."

2. The present *statutory* exceptions are: *Id.* § 453B (relating to disposition of installment obligations); *id.* § 336(b) (relating to disposition of LIFO inventory); *id.* § 1245, *as amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 [hereinafter cited as Tax Reform Act of 1984] (relating to gain from disposition of certain depreciable property); *id.* § 1250, *as amended by* Tax Reform Act of 1984 (relating to gain from disposition of certain depreciable real property); *id.* § 47, *as amended by* Tax Reform Act of 1984 (relating to recapture of investment tax credit).

3. Prior to 1982, § 336(a) applied to partial as well as complete liquidations. *See infra* note 5.

4. Treas. Reg. 45, art. 547 (1919).

5. Internal Revenue Code of 1954, § 336(a), Pub. L. No. 83-591, 68A Stat. 106 (1954) [hereinafter cited as 1954 Code]. As originally enacted, § 336(a) provided: "(a) *General Rule*.—Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." *Id.* The nonrecognition rule embodied in § 336(a) is also embodied in a companion provision, I.R.C. § 337(a) (1982). Section 337(a) provides that, subject to certain exceptions, a liquidating corporation does not recognize gain or loss when it sells its assets as part of a plan of liquidation. Since § 336(a) provided that, as a general rule, corporations would not recognize gain or loss as a result of making liquidating distributions of property to shareholders, Congress concluded that a liquidating corporation should not be deprived of the benefits of § 336(a) simply because the corporation elected to liquidate by selling its assets. These companion provisions will, for the sake of convenience, generally be referred to as the "liquidation nonrecognition provisions."

6. *See supra* note 2.

7. *See Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134, 1153, 75 L. Ed. 2d 130, 157 (1983) ("tax benefit rule" applies to corporations that make liquidating distributions under § 336).

never examined the fundamental question of whether the liquidating corporation should recognize gain or loss when it distributes appreciated or depreciated property to its shareholders in liquidation.

The recent and well-publicized corporate takeover battles fought by Mobil Oil Company and E.I. DuPont de Nemours for control of Conoco Oil Company, and by Mobil Oil Company and United States Steel for control of Marathon Oil Company, attracted congressional attention to the Code's partial liquidation provisions, which arguably provided tax incentives, quite apart from any nontax reasons for engaging in such takeover battles.⁸ Although the legislation that ultimately emerged from this congressional attention⁹ did not change existing complete liquidation rules, the attendant discussion raised questions as to the appropriateness of the liqui-

8. See statement of Rep. Fortney Stark in connection with his introduction of the Corporate Takeover Tax Act of 1982, H.R. 6295, 97th Cong., 2d Sess., 128 CONG. REC. H1937 (daily ed. May 19, 1982):

The objective of the bill is to make the tax system more clearly neutral with respect to corporate takeovers. The tax system should create neither special benefits from nor impediments to mergers, acquisitions, or reorganizations. Unfortunately, our present tax system creates a motive for takeovers quite apart from any opportunity to improve the utilization of productive assets. When the tax advantages of a takeover become significant it is as if the U.S. Treasury provides a part of the funds used to finance the takeover.

128 CONG. REC. H1928 (daily ed. May 6, 1982) (statement of Rep. Stark). See generally A. FELD, *TAX POLICY AND CORPORATE CONCENTRATION* (1982) (complete study of effects of tax structure on corporate organization). Of course, arguments are made on the other side. For example, a spokesperson for U.S. Steel, while conceding that the tax consequences of the acquisition of Marathon Oil Company were important to U.S. Steel, denied that the acquisition was undertaken primarily for tax purposes.

U.S. Steel's D.K. Frick also rejected the notion that a transaction of this size would be undertaken primarily for tax reasons. Frick stated that the tax consequences were certainly important, but he stressed that any tax attributes pale in the face of a \$6 billion expenditure. "Obviously anybody that spends that much for a company tries to have it come out as an asset to some extent for tax purposes," said Frick.

Brown, *Major Tax Savings Go With U.S. Steel—Marathon Merger*, 14 TAX NOTES 562, 564 (Mar. 1, 1982).

9. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 222-228, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 324 [hereinafter cited as TEFRA]. These sections of TEFRA are generally referred to as the "mergers and acquisitions provisions." Congressional interest in this area generated a number of pieces of proposed legislation. See, e.g., H.R. 4562, 97th Cong., 1st Sess., 127 CONG. REC. H6581 (daily ed. Sept. 23, 1981) (First Things First Credit Act of 1981) (proposed amending 1954 Code to deny interest deduction for interest paid on funds borrowed for "unfriendly" takeover or attempted takeover); H.R. 5517, 97th Cong., 2d Sess., 128 CONG. REC. H4406 (daily ed. Feb. 10, 1982) (proposed amending 1954 Code to deny interest deduction on any debt incurred in connection with a corporate takeover if the President determined that use of debt would be harmful to nation's monetary policy); H.R. 5855, 97th Cong., 2d Sess., 128 CONG. REC. H924 (daily ed. Mar. 16, 1982) (proposed amending 1954 Code to deny interest deduction on any debt incurred in connection with an "unfriendly" takeover); H.R. 5719, 97th Cong., 2d Sess., 128 CONG. REC. H664 (daily ed. Mar. 3, 1982) (Merger Tax Act of 1982) (proposed a 15% excise tax on certain acquisitions of business entities); H.R. 6295, 97th Cong., 2d Sess., 128 CONG. REC. H1937 (daily ed. May 6, 1982) (Corporate Takeover Tax Act); S. 2547, 97th Cong., 2d Sess., 128 CONG. REC. S5569 (daily ed. May 19, 1982). Of the proposed legislation, two bills formed the basis for the "mergers and acquisitions provisions" of TEFRA: first, the Corporate Takeover Tax Act of 1982, H.R. 6295, 97th Cong., 2d Sess., 128 CONG. REC. H1937 (daily ed. May 6, 1982); and second, an untitled bill introduced by Sen. Howard Metzenbaum, S. 2547, 97th Cong., 2d Sess., 128 CONG. REC. S5569 (daily ed. May 19, 1982).

dation nonrecognition provisions.¹⁰ The Staff of the Senate Finance Committee is currently considering this question as part of a general study of Subchapter C.¹¹

Thorough congressional examination of the appropriateness of the liquidation nonrecognition provisions, performed as a part of a reevaluation of the theory and operation of Subchapter C, is long overdue. Congress, in approaching this examination, must recognize that repeal of the liquidation nonrecognition provisions would work a fundamental change in our system of income taxation. While no administrative, legislative, or judicial articulation of a theoretical basis for the liquidation nonrecognition provisions has ever been made, that fact alone is not a sufficient reason to repeal the provisions.

The early administrative rule was, very possibly, "derived from a simple notion that there is no realization of appreciation in value at the corporate level unless a corporation receives something or is relieved of a definite, liquidated liability in exchange for its appreciated property."¹² Such a notion was probably grounded in the belief that realization was a constitutional requirement. Now, however, realization is generally agreed to be a matter of administrative convenience, rather than a constitutional mandate. Since the Constitution imposes no restraint on Congress's power to make liquidation distributions taxable events for the liquidating corporation, Congress must decide whether to repeal the liquidation nonrecognition provisions.¹³ As it considers this question, Congress must identify the

10. See Statement of David G. Glickman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means (May 24, 1982), TAX NOTES MICROFICHE DATABASE Doc. No. 82-6117.

11. Senator Robert Dole, Senate Finance Committee Chairman, directed the Finance Committee Staff to study proposals for the revision and simplification of Subchapter C. See Statement of Sen. Robert Dole, October 28, 1982, 17 TAX NOTES 494 (Nov. 8, 1982). On September 22, 1983, the Senate Finance Committee Staff issued a preliminary report setting forth recommendations for revisions to Subchapter C. See STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983) [hereinafter cited as STAFF REPORT]. The Staff Report drew heavily on the American Law Institute study of corporate taxation. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982) [hereinafter cited as ALI PROPOSALS]. Among the recommendations made by the Staff Report was a proposal to repeal the liquidation nonrecognition provisions. On December 20, 1983, the Staff made available an unofficial draft of proposed legislation that included a proposal to repeal the liquidation nonrecognition provisions.

12. ALI PROPOSALS, *supra* note 11, at 105-06.

13. The problems created by the liquidation nonrecognition provisions could be eliminated by integration of the corporate and individual income taxes. Congress does not, however, seem inclined to embrace integration. Indeed, as discussed further in this Article, the proposals for the reform of Subchapter C are directed toward strengthening the corporate tax. Significantly, the ALI Proposals and the Staff Report both begin with the assumption that Congress will not integrate the corporate and individual income taxes. See ALI PROPOSALS, *supra* note 11, at 12, 104, 111-16; STAFF REPORT, *supra* note 11, at 4, 88-93. The discussion in this Article is based on the assumption that the corporate and individual income taxes will not be integrated in the near future.

problems created by the liquidation nonrecognition provisions so that an appropriate response to such problems can be fashioned.

The Senate Finance Committee Staff, which has been primarily responsible for conducting the study of Subchapter C, has recommended complete repeal of the liquidation nonrecognition provisions.¹⁴ In support of its decision, the Staff argues that repeal would simplify Subchapter C, further the cause of tax neutrality, and broaden the tax base.¹⁵ Whatever the merit of these arguments, they obscure the real problem, which is that the present tax system creates the opportunity for a liquidating corporation's distributees to take former corporate assets with a stepped-up basis without any corresponding taxation of the appreciation in the value of the assets. This opportunity exists because of the combined effect of the liquidation nonrecognition provisions and the basis rules applicable to liquidating distributions.¹⁶ While complete repeal of the liquidation nonrecognition provisions would end this improper tax result, repeal is not the appropriate response for all types of liquidations.

A corporate liquidation can be used to accomplish three types of transactions: (1) the termination of a business; (2) the continuation of a corporate business by the shareholders of the corporation in unincorporated form; or (3) the transfer of a business to a third-party purchaser. If a liquidation involves the sale of the corporate assets to a third party, repeal of the liquidation nonrecognition provisions is appropriate. The third-party purchaser expects to get a cost basis in the assets. In order to justify the stepped-up basis, the tax system should impose a tax on the liquidating corporation on the appreciation in value of the assets. The additional tax cost to the liquidating corporation could be the subject of a negotiated adjustment to the asset purchase price. If a liquidation involves either termination of a business or continuation of a business by the former shareholders in an unincorporated form, the appropriate result is to give the liquidating corporation an election. The liquidation could either be a taxable event for the liquidating corporation, with the result that the distributees would receive a stepped-up basis in the assets, or a nonrecognition event for the liquidating corporation, in which case the distributees would receive a carryover basis in the assets.

Any change to the liquidation nonrecognition provisions will cause a substantial alteration in the operation of our existing system of corporate income taxation. Complete repeal of the liquidation nonrecognition provisions could have harsh consequences, particularly to the extent that repeal would result in the imposition of a tax on inflation-created gains. Complete repeal would also raise questions relating to allowance of loss deductions on assets that have declined in value below their adjusted basis at the time of the liquidation. In order to understand the magnitude of the change involved in the repeal of the liquidation nonrecognition provisions,

14. STAFF REPORT, *supra* note 11, at 66-67.

15. *Id.* at 88-91.

16. I.R.C. § 334(a) (1982).

this Article briefly traces the history of the provisions. This Article also examines the arguments for and the effects of complete repeal and the possible temporary or permanent measures that might be employed to lessen the effects of repeal. Finally, this Article proposes an alternative to complete repeal.

I. TREATMENT OF IN-KIND DISTRIBUTIONS IN LIQUIDATION PRIOR TO 1954

Corporations, as separate taxable entities, have been subject to federal income tax since the passage of the first revenue act¹⁷ by Congress pursuant to the sixteenth amendment.¹⁸ The first income tax regulations issued by the Treasury Department¹⁹ made no reference to gain or loss realization or recognition by a corporation that made either a liquidating or non-liquidating distribution of property in-kind to its shareholders with respect to their stock. Following passage of the Revenue Act of 1918,²⁰ the Treasury Department promulgated new Regulations,²¹ first in a preliminary edition²² and then in final, revised form.²³ The preliminary edition, like the first Regulations, made no reference to realization or recognition of gain or loss by the corporation upon an in-kind distribution to its shareholders. The revised Regulations, however, provided: "No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition."²⁴ The identical language appeared in the Treasury Regulations²⁵ issued under the Revenue Act of 1921,²⁶ the Revenue Act of 1924,²⁷ and the Revenue Act of 1926.²⁸

With promulgation of the Revenue Act of 1928,²⁹ the Treasury Department changed the Regulations slightly by replacing the words "upon dissolution" with the words "in partial or complete liquidation."³⁰ Apparently, the only purpose for this amendment was to clarify that both partial liquidations and complete liquidations were covered by this rule. The identical

17. Act of Oct. 3, 1913, Pub. L. No. 63-16, 38 Stat. 166. A corporate income tax had been imposed in 1909, prior to the ratification of the sixteenth amendment. *See* Pub. L. No. 61-5, 36 Stat. 112 (1909).

18. U.S. CONST. amend. XVI.

19. Treas. Reg. 33 (1914).

20. Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919).

21. Treas. Reg. 45 (1919).

22. Released on Feb. 25, 1919.

23. Released on Apr. 21, 1919.

24. Treas. Reg. 45, art. 547 (1919).

25. Treas. Reg. 62, art. 548 (1922) (Revenue Act of 1921); Treas. Reg. 65, art. 548 (1924) (Revenue Act of 1924); Treas. Reg. 69, art. 548 (1926) (Revenue Act of 1926).

26. Pub. L. No. 67-98, 42 Stat. 227.

27. Pub. L. No. 68-176, 43 Stat. 253.

28. Pub. L. No. 69-20, 44 Stat. 9.

29. Pub. L. No. 70-562, 45 Stat. 791.

30. Treas. Reg. 74, art. 71 (1929). As amended, the provision read: "No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition." *Id.*

language appeared in the Treasury Regulations³¹ issued under the Revenue Act of 1932,³² the Revenue Act of 1934,³³ the Revenue Act of 1936,³⁴ the Revenue Act of 1938,³⁵ and the Internal Revenue Code of 1939.³⁶ In 1954 Congress enacted section 336,³⁷ codifying the rule that the Regulations had established administratively.

The Treasury Department never stated a theoretical basis for its administrative position that a liquidating distribution is not a realization event. The Treasury Regulations, in all of their incarnations from 1919 to 1954, did not explain why an in-kind liquidating distribution does not result in corporate realization of gain or loss. A General Counsel Memorandum³⁸ issued in 1926 cites the Treasury Regulations³⁹ for the proposition that no taxable gain results to a corporation that distributes its assets in-kind to its shareholders in liquidation.⁴⁰ Unfortunately, the Memorandum does not discuss the rationale for the position taken in the Regulations and does not present any independent basis for the conclusion that the liquidating distribution does not result in taxable gain to the distributing corporation. Prior to the 1954 Code, courts generally accepted the position of the Regulations without comment or analysis,⁴¹ thereby shedding no additional light on the problem.

While they provided no supporting rationale, the Treasury Regulations clearly embodied the conclusion that an in-kind liquidating distribution is not the type of event that triggers realization of gain or loss to the distributing corporation. This nonrealization position was probably based on the belief that realization could not occur unless the distributing corporation received consideration for the distribution. This hypothesis is supported by the reasoning of early administrative and judicial decisions relating to taxation of corporations that made nonliquidating property distributions. These early decisions distinguished between in-kind dividends, in which the distributing corporations realized no gain or loss,⁴² and cash dividends satisfied by distribution of appreciated or depreciated property, which

31. Treas. Reg. 77, art. 71 (1933) (Revenue Act of 1932); Treas. Reg. 86, art. 22(a)-21 (1935) (Revenue Act of 1934); Treas. Reg. 94, art. 22(a)-21 (1936) (Revenue Act of 1936); Treas. Reg. 101, art. 22(a)-21 (1939) (Revenue Act of 1938); Treas. Reg. 103, § 19.22(a)-21 (1940) (Internal Revenue Code of 1939); Treas. Reg. 118, § 39.22(a)-20 (1953) (Internal Revenue Code of 1939).

32. Pub. L. No. 72-154, 47 Stat. 169.

33. Pub. L. No. 73-216, 48 Stat. 680.

34. Pub. L. No. 74-740, 49 Stat. 1648.

35. Pub. L. No. 75-554, 52 Stat. 447.

36. Pub. L. No. 76-1, 53 Stat. 1.

37. Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3, 106.

38. G.C.M. 714, V-2 C.B. 72 (1926).

39. Treas. Reg. 69, art. 548 (1926).

40. G.C.M. 714, V-2 C.B. at 73.

41. See *Lencard Corp. v. Commissioner*, 47 B.T.A. 58, 60 (1942); *The Dill Mfg. Co. v. Commissioner*, 39 B.T.A. 1023, 1029 (1939); *W.P. Fox & Sons, Inc. v. Commissioner*, 15 B.T.A. 115, 120 (1929); *Chicago Binder & File Co. v. Commissioner*, 4 B.T.A. 1002, 1005 (1926).

42. See *First Utah Sav. Bank v. Commissioner*, 17 B.T.A. 804, 810-11 (1929), *aff'd sub nom.* *First Sav. Bank v. Burnet*, 53 F.2d 919 (D.C. Cir. 1931); *Hollenberg Music Co. v. Commissioner*, 6 B.T.A. 421, 425 (1927); see also *Office Dec. 262*, 1 C.B. 28 (1919) ("When

caused the distributing corporation to realize and recognize gain or loss.⁴³ The decisions emphasized that the distributing corporation had to receive some sort of consideration in order to trigger realization.⁴⁴ These early decisions set the stage for *General Utilities & Operating Co. v. Helvering*,⁴⁵ with results, as one commentator put it, hardly foreseeable by the United States Supreme Court.⁴⁶

dividends are paid in Liberty Bonds having a market value below par the difference between par and market is not an allowable deduction for income tax purposes.”).

43. See Committee on Appeals Review, Recommendation 435, 4 C.B. 27 (1921) (corporation declared a dividend and subsequently satisfied dividend using depreciated securities, difference between value of securities on March 1, 1913, and value on distribution allowed as loss deduction to corporation). The Committee expressed the basis for its recommendation as follows:

At the date of the dividend the taxpayer unquestionably parted with title to these securities and thus closed the transaction in them. Therefore, if the net value of the securities at that date was less than their net value on March 1, 1913, the taxpayer, as a matter of fact, sustained a loss in their distribution. . . .

Id. at 28; see also *Bacon-McMillan Veneer Co. v. Commissioner*, 20 B.T.A. 556, 559 (1930) (realization of gain due to use of appreciated property to satisfy dividend obligation); *Callanan Road Improvement Co. v. Commissioner*, 12 B.T.A. 1109, 1111 (1928) (loss sustained upon discharge of obligation by means of distribution of depreciated property).

44. Perhaps the clearest articulation of the reasoning in these early decisions can be found in *First Utah Sav. Bank v. Commissioner*, 17 B.T.A. 804 (1929), *aff'd sub nom. First Sav. Bank v. Burnet*, 53 F.2d 919 (D.C. Cir. 1931). In *First Utah* the taxpayer distributed depreciated securities to its shareholders as a dividend in-kind. The taxpayer claimed a loss on the distribution equal to the difference between the cost of the securities and their market value when they were distributed to the shareholders. The loss was denied, and the taxpayer took the matter before the Board of Tax Appeals. Both the Board and the court of appeals upheld the Commissioner's disallowance of the loss, and both focused on the argument that § 202(a) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227, 229-31, required a “sale or other disposition” of the securities before gain or loss could be recognized. The court of appeals concluded that the distribution of the securities as an in-kind dividend was clearly not a “sale.” 53 F.2d at 920. Thus, the court stated:

The question remains whether the transfer, even if not a sale, responds to the description of “other disposition of property,” as employed in the statute. This question is not free from doubt, but we feel constrained to hold that the rule of *eiusdem generis* is applicable in construing the phrase, and that it relates only to such dispositions of property as are like sales. The transfer in question was not of this kind for the stockholders of the bank paid no consideration for the stock received by them, nor was it received in payment of any cash dividend previously declared by the bank.

Id. at 920-21. The court of appeals went on to cite Treas. Reg. 45, art. 547 (1919), and successor provisions, stating:

No difference exists in principle between mere distributions of assets by corporations in dissolution and those not in dissolution. In both instances alike such assets are merely distributed among the stockholders of the corporation without the payment of any consideration therefor, and without the prior declaration of any cash dividend in payment of which the distribution is made.

53 F.2d at 921. Although the court of appeals acknowledged the taxpayer's actual loss of value, it held that no loss was realized for income tax purposes, concluding, somewhat cryptically, that “the income tax laws do not profess to embody perfect economic theory. They have their own criteria which at times look to certain rather severe tests of liability and exemption.” *Id.*

45. 296 U.S. 200 (1935).

46. Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 130 (1977).

II. THE *GENERAL UTILITIES* "DOCTRINE"

General Utilities & Operating Co. purchased 20,000 of the 40,000 outstanding shares of the common stock of Islands Edison Company for \$2,000. Gillet & Company owned the remaining 20,000 shares of Islands Edison common stock. Southern Cities Utilities Company desired to acquire all of the Islands Edison stock. The president of Southern Cities discussed the acquisition of the Islands Edison stock with the presidents of General Utilities and Gillet. The three presidents reached an understanding as to the terms and conditions under which Southern Cities might be able to purchase the Islands Edison stock. Gillet was prepared to sell its Islands Edison stock to Southern Cities directly, but General Utilities wished, in order to avoid double taxation of the sale proceeds, to distribute its Islands Edison stock to its shareholders who would, as individuals, sell the stock to Southern Cities. The understanding reached by the three presidents included an agreement that General Utilities would distribute its Islands Edison stock to its shareholders and that Southern Cities would then have to acquire the Islands Edison stock from the General Utilities shareholders.

Following these discussions, the board of directors of General Utilities determined the value of the 20,000 shares of Islands Edison stock owned by General Utilities to be \$56.125 per share, for a total value of \$1,122,500, and adopted the following resolutions:

That a dividend in the amount of \$1,071,426.25 be and it is hereby declared on the Common Stock of this Company payable in Common Stock of The Islands Edison Company at a valuation of \$56.12 1/2 a share, out of the surplus of the Company arising from the appreciation in the value of the Common Stock of the Islands Edison Company held by this Company, viz, \$1,120,500.00, the payment of the dividend to be made by the delivery to the stockholders of this Company pro rata, of certificates for the Common Stock of The Islands Edison Company held by this Company at the rate of two shares of such stock for each share of Company Stock of this Corporation.⁴⁷

Pursuant to the resolution, General Utilities distributed 19,090 of its 20,000 shares of Islands Edison stock to its shareholders, retaining the remaining 910 shares. Following this distribution, all of the shareholders of General Utilities sold their shares of Islands Edison stock to Southern Cities. General Utilities simultaneously sold its 910 shares of Islands Edison stock to Southern Cities. The selling price for all of the shares was \$56.125 per share. General Utilities duly reported its gain on the sale of the 910 shares, but reported no gain as a result of its distribution of the 19,090 shares to its stockholders.

The Commissioner determined that the distribution of the 19,090 shares gave rise to a taxable gain to General Utilities of \$1,069,517.25.⁴⁸ General Utilities petitioned the Board of Tax Appeals for a review of the Commis-

47. 296 U.S. at 202.

48. The amount of the taxable gain was computed as follows:

sioner's determination.⁴⁹ The Commissioner argued that General Utilities, pursuant to its dividend resolution, became indebted to its shareholders in the amount of \$1,071,426.25, satisfied its debt using appreciated property, and therefore, realized a gain equal to the difference between the value of the property on the date of distribution and its basis. Noting that the only issue before it was "whether petitioner realized taxable gain in declaring a dividend and paying it in the stock of another company at an agreed value per share, which value was in excess of the cost of the stock to petitioner,"⁵⁰ the Board found in favor of General Utilities. The Board distinguished those early cases in which a nonliquidating distribution was found to have caused realization, arguing that those cases involved declarations of dividends that were stated in definite amounts prior to payment of the dividends by distributions in-kind, whereas the General Utilities dividend declaration initially declared a dividend in-kind.⁵¹

19,090	Shares Sold
× \$56.125	Per Share Purchase Price
\$1,071,426.25	Total Purchase Price
19,090	Shares Sold
× \$ 0.10	Per Share Basis
\$1,909.00	Total Basis
\$1,071,426.25	Purchase Price
– 1,909.00	Basis
\$1,069,513.25	Gain

Id. at 202-03.

49. *General Utils. & Operating Co. v. Commissioner*, 29 B.T.A. 934 (1934).

50. *Id.*

51. The Board cited *Callanan Road Improvement Co. v. Commissioner*, 12 B.T.A. 1109 (1928) (loss sustained upon discharge of dividend obligation by means of distribution of depreciated property); *Bacon-McMillan Veneer Co. v. Commissioner*, 20 B.T.A. 556 (1930) (realization of gain due to use of appreciated property to satisfy dividend obligation); and *First Utah Sav. Bank v. Commissioner*, 17 B.T.A. 804, *aff'd sub nom. First Sav. Bank v. Burnet*, 53 F.2d 919 (D.C. Cir. 1931) (no loss allowed on distribution of securities as dividend in-kind). The Board distinguished *Callanan* and *Bacon-McMillan* from *General Utilities* based on the dividend resolutions adopted in each case. The distinction between the resolution in *Callanan* and the resolution in *General Utilities* is clear, since in *Callanan* the company declared a cash dividend with no mention of the property that was later distributed in partial satisfaction of the cash amount owed. The distinction between the resolution in *Bacon-McMillan* and the resolution in *General Utilities* is, however, not at all clear. In *Bacon-McMillan* the resolution provided: "[T]hat a fifty per cent dividend be declared, and made payable in Liberty Loan Bonds in denominations of \$1,000.00 each at their market value this date, and all odd hundreds of dollars and cents in cash." *Id.* at 557. In *General Utilities* the resolution provided: "[T]hat a dividend in the amount of \$1,071,426.25 be and it is hereby declared . . . payable in Common Stock of The Islands Edison Company" 29 B.T.A. at 936. The Board of Tax Appeals in *Bacon-McMillan* concluded:

On the question of dividends payable in Liberty Loan Bonds, the real controversy centers around the interpretation of the resolution of the board of directors in declaring the dividend. If the resolution be interpreted as declaring an ordinary dividend of a definite amount and then providing that that dividend should be paid in Liberty bonds, we think that [the distribution of the Liberty Bonds constituted a realization of gain by the corporation.]

20 B.T.A. at 559. In *General Utilities* the Board of Tax Appeals stated: "Where the method of payment is prescribed a stockholder is not entitled to payment in some other form." 29 B.T.A. at 940. Since the resolution in *Bacon-McMillan* prescribes the method of payment in almost the same words as the resolution in *General Utilities*, is it possible to reconcile these

Based on its analysis of prior cases, the Board concluded "that, where the dividend resolution imposes only the obligation to distribute in kind and it is discharged in that way, no gain or loss results to the corporation."⁵²

The Commissioner appealed to the Fourth Circuit, asserting not only the cash dividend argument raised before the Board, but also an alternative argument that General Utilities should be taxed on the shareholders' sale of the 19,090 shares because General Utilities had in fact sold the stock. Foreshadowing the argument in *Commissioner v. Court Holding Co.*,⁵³ the Commissioner argued that General Utilities did everything except actually consummate the sale of the shares and thus should not escape taxation on the sale by the device of a dividend distribution to its shareholders. The court of appeals held that the Board correctly decided the dividend question, but reversed the Board on the basis of the Commissioner's new argument.⁵⁴

On appeal to the United States Supreme Court, the Commissioner made a third argument, which asserted that, by making the appreciated value of the Islands Edison stock available to its shareholders, General Utilities effectively realized that appreciation and should be taxed on it.⁵⁵ The Court did not respond directly to this new argument and held only that the court of appeals erred in hearing the Commissioner's second argument because that argument was not raised before the Board.⁵⁶ Presumably the same rationale would apply to the Commissioner's realization argument, since it was raised for the first time before the Supreme Court, but regrettably the Court's opinion is silent on that point. The Court reversed the court of appeals and affirmed the result reached by the Board.⁵⁷

The Court's holding in *General Utilities* is not a model of clarity:

Both the tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the Islands Edison shares as a dividend. There was no sale; assets were not used to discharge indebtedness.

The second ground of objection, although sustained by the [court of appeals], was not presented to or ruled upon by the Board. The petition for review relied wholly upon the first point; and, in the circumstances, we think the [court of appeals] should have considered no

two decisions? One might argue that the resolution in *Bacon-McMillan* was for a fixed amount in no way dependent upon the value of the Liberty Bonds, while in *General Utilities* the resolution was for a dividend of the stock in-kind, with the amount being mentioned only to fix the value of the Islands Edison stock. A better view, however, is that, to the extent that *Bacon-McMillan* held that a resolution naming the amount of a dividend and then providing that the dividend will be paid in property would trigger realization of gain to the distributing corporation upon the distribution of the property, *Bacon-McMillan* has been overruled by subsequent decisions. See Mintz & Plumb, *Dividends in Kind—The Thunderbolt and the New Look*, 10 TAX L. REV. 41, 44 n.15 (1954)

52. 29 B.T.A. at 939.

53. 324 U.S. 331 (1945).

54. *Helvering v. General Utils. & Operating Co.*, 74 F.2d 972, 977 (4th Cir. 1935).

55. Brief for Respondent at 18, 26, *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

56. 296 U.S. at 206.

57. *Id.* at 207.

other.⁵⁸

Commentators have interpreted this language in two opposite ways. The first interpretation, adopted by most commentators, is that the Court simply did not consider the Commissioner's realization argument at all, holding only that on the specific facts of *General Utilities* the distribution of appreciated property as a dividend did not generate discharge of indebtedness income to the distributing corporation.⁵⁹ The second interpretation is that the Court considered and rejected the Commissioner's realization argument, holding that the appreciation in value of corporate assets distributed as a dividend cannot be taxable to the distributing corporation because such a distribution does not constitute a realization of income.⁶⁰ Although the rationale for the second interpretation is not set forth by the commentator, the rationale must be that after the Board and the Court decided that the Islands Edison stock was distributed as a dividend in-kind and not in satisfaction of a cash dividend, both the Board and the Court had to decide that the distribution itself was not a realization event. The difficulty with this argument is that both the Board and the Court could have assumed that mere distribution was not a realization event without actually deciding that issue. As Bittker and Eustice point out, "there is a big difference between answering a question and assuming an answer in the absence of timely argument."⁶¹

Although the vast majority of commentators agreed that, properly read, the Supreme Court's opinion did not address the question of whether a

58. *Id.* at 206.

59. One commentator stated: "Closely read, the opinion does little more than reject the argument that when a corporation declares a dividend in a specified dollar amount and then pays it by distributing appreciated property of equivalent value, it realizes income by virtue of the doctrine that a discharge of indebtedness yields income." Clark, *supra* note 46, at 130; see also Paul, *Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions*, 51 HARV. L. REV. 40, 57 (1937) (interpreting tax law on corporate distributions); Raum, *Dividends in Kind—Their Tax Aspects*, 63 HARV. L. REV. 593, 597-99 (1950) (discussing *General Utilities* holding).

60. Another commentator stated:

Whatever one may feel about the merit of [the Supreme Court's decision in *General Utilities*], it clearly upholds the view of the Board that the appreciated value of a dividend in kind does not constitute income to the distributing corporation. . . .

Nevertheless, it is still maintained that the *General Utilities* case does not stand for the proposition that appreciated value of corporate assets distributed as a dividend in kind cannot be taxable income. The argument . . . is based on the dubious theory that the Court, ignoring the commissioner's last arguments, decided the case solely on the question of whether the dividend has been declared in terms of dollars or in terms of property. The contention completely misses the point that even if the Court did refuse to note the Commissioner's belated attempt to revive an argument he had conceded at trial, its decision that the dividend was in terms of property rather than dollars was significant only because a dividend of property was regarded as incapable of constituting realization of income to the corporation.

Albrecht, "Dividends" and "Earnings or Profits," 7 TAX L. REV. 157, 212-13 (1952) (emphasis added).

61. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.21, at 7-51 n.126 (4th ed. 1979).

distribution of appreciated property is a realization event for a distributing corporation, the courts have not reached the same conclusion. Prior to the enactment of section 311(a),⁶² the lower federal courts, with a few exceptions,⁶³ cited the Court's opinion in *General Utilities* without comment or analysis for the proposition that the distribution of a dividend in-kind would not cause realization of gain or loss by the distributing corporation.⁶⁴ *General Utilities* has also been cited, without comment, as support for the proposition that a liquidating corporation does not realize gain or loss upon distribution of its property to its shareholders.⁶⁵ Such was the state of the law as Congress began the process of drafting the 1954 Code.

III. THE 1954 CODE

When Congress began the revision of the Internal Revenue Code of 1939, it had available for its consideration a substantial and somewhat confusing body of law relating to the taxation of corporations making property distributions to shareholders with respect to their stock. By enacting sections 336(a) and 311(a) in the 1954 Code, Congress ended most litigation on the issue of corporate realization of gain or loss on distributions to its shareholders.⁶⁶ An examination of the records of congressional action relating to the 1954 Code indicates that Congress did not substantively consider whether the pre-1954 Code results, codified in sections 336(a) and 311(a) were proper.

62. I.R.C. § 311(a) (1982) provides: "(a) *General Rule.*—Except as provided in subsections (b), (c), and (d) of this section and section 453B, no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—(1) its stock (or rights to acquire its stock), or (2) property."

63. See *Commissioner v. Godley's Estate*, 213 F.2d 529 (3d Cir. 1954), in which the court of appeals, discussing the Supreme Court's decision in *General Utilities* stated:

Because of procedural points involved and the sequence of the Commissioner's argument before the Board of Tax Appeals, the Fourth Circuit, and the Supreme Court, the scope of the holding of the *General Utilities* case is uncertain. There is no doubt, however, that the case has received judicial and administrative acceptance as standing for the proposition that a corporation does not realize income from the distribution of property which has appreciated in value over its costs.

Id. at 531.

64. See *National Gasoline Corp. v. Commissioner*, 219 F.2d 682 (10th Cir. 1955); *J.A. Folger & Co. v. Commissioner*, 4 T.C.M. 710 (1945); *National Carbon Co. v. Commissioner*, 2 T.C. 57 (1943).

65. See *Union Starch & Ref. Co. v. Commissioner*, 31 T.C. 1041, 1046 (1959).

66. Some litigation did continue, most notably that involving the question of whether the tax benefit rule should be applied notwithstanding the general rule of nonrecognition established by I.R.C. §§ 311(a) and 336(a). *Ballou Constr. v. United States*, 81-2 U.S.T.C. 9638 (D. Kan. 1981); *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978); *Commissioner v. South Lake Farms*, 36 T.C. 1027 (1961), *aff'd*, 324 F.2d 837 (9th Cir. 1963). The Supreme Court's recent decision in *Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134, 1153, 75 L. Ed. 2d 130, 157 (1983), ended the debate over whether the tax benefit rule overrides § 336(a). Continued litigation of the question of when the rule is to be applied appears likely in light of the Court's holding that "the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction." *Id.* at 1138, 75 L. Ed. 2d at 139.

As initially introduced in the House of Representatives, H.R. 8300,⁶⁷ which evolved into the 1954 Code as finally enacted by Congress, dealt in the same section with the income tax consequences to the distributing corporation of both nonliquidating and liquidating distributions.⁶⁸ The drafters of proposed section 308 did not explain why they elected to put the provisions governing both liquidating and nonliquidating distributions into a single section. The combining of these provisions could be read as an indication that the drafters viewed liquidating and nonliquidating distributions as essentially the same for income tax purposes. Such a view would have been compatible with the view expressed by the court in *First Savings Bank v. Burnet*.⁶⁹ In *First Savings* the court stated that it saw no difference in principle between liquidating and nonliquidating distributions because "[i]n both instances alike such assets are merely distributed among the stockholders of the corporation without the payment of any consideration therefore"⁷⁰ Unfortunately, the record does not indicate whether the drafters of proposed section 308 were influenced by the rationale of *First Savings*.

The two published House reports on H.R. 8300 do not shed much additional light on the rationale of the drafters. Both the report of the House Committee on Ways and Means⁷¹ and the Detailed Discussion of Techni-

67. H.R. 8300, 83d Cong., 2d Sess., 100 CONG. REC. 2957 (1954).

68. H.R. 8300, § 308, 83d Cong., 2d Sess., 100 CONG. REC. 2957 (1954) [hereinafter referred to as proposed § 308]. As initially drafted proposed § 308 provided:

Sec. 308. CORPORATE DISTRIBUTIONS OF STOCK, SECURITIES, AND PROPERTY—EFFECT ON CORPORATION.

(a) *In General*.—Except as provided in subsections (b) and (c), no gain or loss shall be recognized to a corporation upon the distribution, with respect to its stock, of its participating or nonparticipating stock (or of rights to acquire such stock) or upon such a distribution of securities or property.

(b) *LIFO Inventory*.—In the case of a distribution of inventory with respect to which a corporation is using the elective method provided by section 472 in the computation of its income, gain shall be recognized to the distributing corporation in an amount equal to the excess of the amount at which such inventory would have been included for the taxable year of such distribution in such computation under a method authorized by section 471 over the amount at which such assets would have been included pursuant to section 472. For this purpose, the amount determined under section 471 shall be computed by the use of the retail method of valuing inventory if the distributing corporation used such method in computing its inventory under section 472 and in all other cases by the use of the method of cost or market, whichever is lower.

(c) *Property Subject to Liability*.—In any case in which property subject to a liability in an amount in excess of the adjusted basis thereof is distributed by a corporation, gain shall be recognized to the distributing corporation with respect to such property measured by the excess of the amount of the liability over the adjusted basis.

(d) *Liquidations*.—Subsection (a) (but not subsections (b) or (c)) shall apply to a distribution in partial or complete liquidation as discussed in section 336.

69. 53 F.2d 919 (D.C. Cir. 1931).

70. *Id.* at 921.

71. REPORT OF HOUSE COMMITTEE ON WAYS AND MEANS, H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4017 [hereinafter

cal Provisions of the Bill appended to the Ways and Means Report⁷² suggest that the drafters incorrectly assumed that *General Utilities* decided that corporate distributions of property to shareholders with respect to their stock were not realization events. Since neither the Ways and Means Report nor the House Technical Discussion contains any analysis of the *General Utilities* decision, a good argument can be made that the drafters concluded that they were bound by what they perceived to be the rule of *General Utilities*. If in fact the drafters believed that *General Utilities* was dispositive on the realization issue, then the following language in the Ways and Means Report indicates that the drafters agreed with the case's result: "Your committee's liquidation rules conform to its policy of not imposing a tax until there has been an economic realization of gain. Accordingly, unrealized appreciation in the value of property received upon the liquidation of a corporation will not be taxed to the shareholder or the corporation."⁷³ Implicit in the reference to unrealized appreciation is the premise that the liquidating distribution is not a realization event. The Ways and Means Report, however, does not explain why a liquidating distribution is not a realization event.

If we assume that the drafters grounded the nonrecognition rule of proposed section 308 in a misplaced reliance on *General Utilities*, another and potentially more serious error arises from the drafters' reading of *General Utilities*. The drafters apparently assumed that the *General Utilities* "rule" applied to liquidating distributions as well as to nonliquidating distributions. Since *General Utilities* involved a nonliquidating distribution, the Court had no occasion to consider the question of whether a liquidating distribution is a realization event. Even if *General Utilities* were binding on the question of nonliquidating distributions, it clearly was not binding on the question of liquidating distributions. The language of the Ways and Means Report on the liquidation provision⁷⁴ arguably may indicate that the drafters were not relying on *General Utilities* to support the non-

cited as WAYS AND MEANS REPORT]. The Ways and Means Report contains the following statement on proposed § 308:

The bill incorporates in the statute a rule derived from the Supreme Court decision in *General Utilities & Operating Co. v. Helvering* (296 U.S. 200) that a corporation does not realize a gain by reason of a distribution of its property even though the value of the property distributed may exceed its cost to the corporation.

Id. at 37.

72. H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4137 [hereinafter cited at HOUSE TECHNICAL DISCUSSION]. The House Technical Discussion contains a statement similar to the statement in the Ways and Means Report:

Section 308 is intended to provide statutory rules governing the tax consequences at the corporate level of distributions of stock, securities, or property to shareholders of a corporation. While this section has no counterpart under the 1939 Code, certain court decisions have been considered to hold that a corporation realizes no gain or loss upon a distribution of property to its shareholders.

Id. at 90.

73. WAYS AND MEANS REPORT, *supra* note 71, at 38.

74. *Id.*

recognition provision of proposed section 308(d). If such an argument is correct, we are left with a provision that apparently was based on the theory that a liquidating distribution does not trigger realization of gain or loss, yet we have no explanation of why no realization occurs.

When considering H.R. 8300, the Senate separated the provisions treating current, nonliquidating, distributions from the provisions treating liquidating distributions. The fact that the Senate elected, unlike the House, to place the provisions relating to liquidating and nonliquidating distributions in separate sections suggests that the Senate viewed the two types of distributions differently. Review of the Report of the Senate Committee on Finance⁷⁵ and the Detailed Discussion of the Technical Aspects of the Bill appended to the Finance Committee Report⁷⁶ suggests that the Senate, while reaching the same result reached by the House, had a different reason for providing for nonrecognition in connection with liquidating distributions. The Senate Technical Discussion of proposed section 336 stated that the provision was derived from the Treasury Regulations.⁷⁷ Although the Senate Technical Discussion correctly identified the source of the rule set forth in proposed section 336, the discussion did not state the rationale for the rule.

As the foregoing discussion indicates, the process of adopting the 1954 Code presented Congress with an opportunity for a critical review of the body of judicial and regulatory law relating to the tax consequences to distributors of liquidating distributions to shareholders. Congress, however, elected to codify the results of the judicial and regulatory decisions

75. REPORT OF SENATE COMMITTEE ON FINANCE, S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621 [hereinafter cited as FINANCE COMMITTEE REPORT].

76. S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4785 [hereinafter cited as SENATE TECHNICAL DISCUSSION].

77. The Finance Committee Report on proposed § 311 (nonliquidating distributions) provides:

Your committee follows the house bill in retaining the general rules of present law with respect to current distribution by a corporation to its shareholders. Your committee also incorporates into the statute the rule derived from the Supreme Court decision in *General Utilities and Operating Company v. Helvering* (296 U.S. 200) that a corporation does not realize gain by reason of a distribution of its property even though the value of the property distributed may exceed its cost to the corporation.

FINANCE COMMITTEE REPORT, *supra* note 75, at 46. This language, which is virtually identical to the language of the Ways and Means Report, reflects the influence of *General Utilities*. Contrast, however, the language of the Senate Technical Discussion dealing with proposed § 336:

This section, for which there is no statutory counterpart under existing law, corresponds to section 308(a) of the House bill and provides that no gain or loss shall be recognized to a corporation on the distribution of property in kind in partial or complete liquidation. This rule is derived from section 39.22(a)-20 of Regulations 118.

SENATE TECHNICAL DISCUSSION, *supra* note 76, at 258. The Senate Finance Committee apparently understood that it was proposing to codify the rule that had existed in the Treasury Regulations since 1919. Although the Senate Technical Discussion makes reference to proposed § 308(a) of the House bill, which covered both liquidating and nonliquidating distributions, the Senate Technical Discussion clearly does not seek to explain proposed § 336 as being required by *General Utilities*.

without considering the appropriateness of those results. Since the adoption of the 1954 Code, Congress has never given this important area the attention it deserves.⁷⁸

IV. SHOULD A LIQUIDATING DISTRIBUTION BE A RECOGNITION EVENT?

Congress now has the opportunity to give the liquidation nonrecognition provisions the attention they deserve. Congress in considering whether to repeal these provisions, must address two questions. First, could any valid constitutional objections to repeal be raised? The answer to this question turns on whether the sixteenth amendment requires realization of gain as a prerequisite to its recognition, or whether the requirement is merely a matter of administrative convenience. Second, if no constitutional problem exists, is liquidation an appropriate event to trigger both a tax on the appreciation in value of corporate assets and a loss deduction for depreciation in value of such assets? The answer to this question turns on an understanding of what problems the liquidation nonrecognition provisions create and how repeal would help resolve those problems.

A. *Is Realization Required by the Sixteenth Amendment?*

The question of a possible sixteenth amendment problem can be disposed of quickly. In *Eisner v. Macomber*⁷⁹ the Supreme Court stated that the sixteenth amendment requires realization, which the Court defined as the severance of gain from capital. The Court has since discarded this definition of realization. Instead the question has become whether some event has occurred that marks an appropriate time to tax the appreciated value of an asset.⁸⁰ The Court, however, has never expressly repudiated that portion of *Eisner v. Macomber* that made realization, however defined, a constitutional requirement.⁸¹ The lack of repudiation could be said to support the argument that realization is a constitutional requirement,⁸²

78. Shortly after the enactment of the 1954 Code, Congress commissioned a study of the federal income tax laws. In 1959 a collection of reports comprising this study was published. Included in this collection was the seminal article by James Lewis proposing fundamental change in the tax treatment of liquidating corporations. Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidations*, 3 HOUSE COMMITTEE ON WAYS AND MEANS TAX REVISION COMPENDIUM 1643 (1959). The Lewis article was not, however, the subject of any congressional discussion.

79. 252 U.S. 189, 207 (1920).

80. *United States v. Davis*, 370 U.S. 65, 68 (1962); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

81. When the government has specifically asked the Court to overrule *Eisner v. Macomber*, the Court has avoided taking such action by distinguishing *Eisner v. Macomber* from the case before the Court. See *Helvering v. Sproule*, 318 U.S. 604, 607 (1943); *Helvering v. Griffiths*, 318 U.S. 371, 394 (1942). Thus, *Eisner v. Macomber* may still have some vitality at least to the extent of holding that realization is required by the sixteenth amendment. See Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 176 (1964).

82. The question of whether realization is constitutionally required has persisted, pri-

even though lower federal courts have not been receptive to the idea⁸³ and most commentators agree that realization is a matter of administrative convenience.⁸⁴

Fortunately, even in the unlikely event that the sixteenth amendment requires realization, that requirement is only of limited importance. As one commentator explained:

The constitutional requirement of realization, if it ever made any sense, did so only in connection with a tax on a gain from property which could be regarded as a tax on the property itself if it was not treated as a tax on income A tax upon a gain which is not a direct tax upon property does not have to be sustained under the sixteenth amendment. Consequently, even upon the assumption that realization is a constitutional prerequisite of income, such a gain need not be realized to be constitutionally taxable.

As long as there is an adequate gain to sustain an income tax, it would seem that the question of when this gain should be taxed, or when it was realized for tax purposes, should be a matter of administrative convenience to be decided by Congress, rather than a constitutional question whose ultimate resolution rests with the courts.⁸⁵

If the foregoing rationale is applied to the specific problem of the corporate liquidating distribution, when a corporation distributes its property in liquidation any appreciation in value over the corporation's basis in such property can be measured as of the date of the liquidating distribution. In such a situation, the gain would be adequate to sustain an income tax.⁸⁶

marily in the area of transfers of property by gift. The issuance of two Internal Revenue Service rulings relating to the realization of gain by virtue of a gift of harvested wheat, I.T. 3910, 1948-1 C.B. 15, and a gift of cattle, I.T. 3932, 1948-2 C.B. 7, prompted a series of articles discussing whether the government could impose an income tax on the donor on the accrued gain at the time of the gift. Griswold, *Charitable Gifts of Income and the Internal Revenue Code*, 65 HARV. L. REV. (1951); Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375 (1952); Griswold, *In Brief Reply*, 65 HARV. L. REV. 1389 (1952); Roehner & Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953). Similarly, the debate on the appropriateness of the exclusion for gifts embodied in § 102(a) prompted comment on the power of Congress to impose an income tax on either the donor or the donee at the time of the gift. See Mullock, *The Constitutional Problem of Taxing Gifts as Income*, 53 MINN. L. REV. 247 (1968); Del Cotto, *The Constitutional Problem of Taxing Gifts as Income: A Reply to Professor Mullock*, 53 MINN. L. REV. 259 (1968). A proposal to impose an income tax on unrealized appreciation in property at death, H.R. 8757, § 2(a), 92d Cong., 1st Sess. (1971), drew strong criticism as being in violation of the sixteenth amendment. See Comment, *Proposed IRS § 84: Income Taxation of Unrealized Appreciation at Death: Unwise; Unwieldy; Unconstitutional*, 34 U. PITT. L. REV. 23 (1972). But see Graetz, *Taxation of Unrealized Gains at Death: An Evaluation of Current Proposals*, 59 VA. L. REV. 830 (1973) (favoring taxation of unrealized gains upon death of taxpayer).

83. See *Prescott v. Commissioner*, 561 F.2d 1287, 1293 (8th Cir. 1977).

84. See Lowndes, *supra* note 81, at 173; Oberst, *Reform of the Subchapter S Distribution Rules: Repudiation of Section 311(a)*, 38 TAX L. REV. 79, 114-15 (1982); Roehner & Roehner, *supra* note 82.

85. Lowndes, *supra* note 81, at 172-73. But see Mullock, *Current Conceptions of Taxable Income—A Comment*, 26 OHIO ST. L.J. 43 (1965) (disagrees with Lowndes article and supports realization requirement).

86. While the amount of the increase or decrease in the value of marketable securities

Congress, therefore, should be free to decide, without regard to any constraints imposed by the sixteenth amendment, whether distributing corporations must realize and recognize such gains.

B. Is a Liquidating Distribution an Appropriate Taxable Event?

1. Preliminary Comments

Even if no constitutional impediment bars a congressional decision to repeal the liquidation nonrecognition provisions, the difficult question of whether such action is appropriate still remains. The mere fact that the liquidation nonrecognition provisions are not the product of careful congressional deliberation does not require the conclusion that the provisions must be repealed. Indeed, the proposals to repeal the liquidation nonrecognition provisions raise fundamental questions about the extent to which double taxation should be imposed. The provisions represent a long-standing administrative and statutory practice that should not be cast aside without careful thought. Despite separate corporate and individual income taxes, in practice complete double taxation under these systems is not imposed. Our two-tier tax system is in effect a compromise, under which double taxation is imposed on ordinary earnings from regular business operations, but only a single tax, at the shareholder level, is imposed on extraordinary events, such as corporate liquidations.⁸⁷ Repeal of the

held by a liquidating corporation can be measured in relation to the corporation's adjusted basis in such securities at the time of the liquidating distribution, any gains or losses determined in that manner are arguably merely paper gains or losses without sufficient economic substance to justify taking them into account in computing tax liability. Although securities values do fluctuate, if the Constitution does not require realization, the amount of gain or loss can be calculated as of the date of distribution. The issue raised by such an argument, therefore, is not whether such gain or loss can be recognized, but whether such gain or loss should be recognized. Other types of gains, such as gain attributable to goodwill, might be difficult to measure with accuracy and for that reason should, as discussed further, be treated separately.

87. *Reform of Corporate Taxation: Hearing Before Committee on Finance, U.S. Senate, 98th Cong., 1st Sess. 158 (1983)* [hereinafter cited as *Finance Hearing on Reform of Corporate Tax*] (statement of John S. Nolan). Why our corporate income tax has developed in such a schizophrenic fashion is unclear. Professor Alvin Warren's article on the integration of the individual and corporate income taxes suggests a possible explanation. Warren, *The Relation and Integration of Individual and Corporate Income*, 94 HARV. L. REV. 719 (1981). Professor Warren points out that initially corporations were viewed as separate taxable entities simply because they were legal entities. *Id.* at 719. If Congress shared this view in 1909, adoption of the corporate income tax in that year might be explained as an attempt to insure that corporations, as legal entities, would bear their fair share of the tax burden. As Professor Warren acknowledges, however, the view that the corporation is a separate taxable entity merely because it is a separate legal entity "has generally given way to the view that the burden of all taxes must ultimately fall on individuals." *Id.* The modern view of the corporate income tax, according to Professor Warren, is that the tax is "a separate tax on corporate 'profits' (i.e., the excess of a corporation's net income over the cost of its capital) or on entrepreneurship." *Id.* Professor Warren's comments suggest that the development of our corporate income tax system reflects the tension between the desire to use the corporate income tax as a convenient means of raising revenue and the desire to make the tax system as neutral as possible with regard to the decision to use a corporation as a vehicle for operating a business. The latter purpose produced the nonrecognition provisions embodied in §§ 351, 336 & 337. The former purpose resulted in the double tax on the proceeds of the normal business operations of corporations.

liquidation nonrecognition provisions would work a fundamental change in the operation of our tax system, regardless of that system's supporting theory. The appropriate argument is not that Congress should give undue weight to past history,⁸⁸ but rather that Congress should only repeal the liquidation nonrecognition provisions after careful consideration of all of the possible effects that could result from repeal.⁸⁹

Proponents of complete repeal of the liquidation nonrecognition provisions argue that the provisions are the source of a number of problems in our existing corporate income tax laws. While the provisions do create or contribute to several problems, Congress needs to recognize that the most serious problem is that taxpayers can, by utilizing the liquidation nonrecognition provisions and the liquidation basis provisions, step up the basis of corporate assets without exposing the appreciation in the value of such assets to taxation. Both the ALI Proposals⁹⁰ and the Staff Report⁹¹ begin by proposing complete repeal of the liquidation nonrecognition provisions. This proposition is based on the potential benefits that would flow from repeal. The principal arguments advanced in support of complete repeal are as follows: (1) repeal would simplify Subchapter C; (2) repeal would further the cause of tax neutrality; and (3) repeal would broaden the federal income tax base. These arguments, which are evaluated below, tend to deflect attention from the real problem, which is the opportunity to get a stepped-up basis without imposition of a corresponding tax. Although complete repeal would resolve some problems, including the stepped-up basis problem, complete repeal would also create new problems. For that reason, the less drastic approach of partial repeal of the provisions, coupled with an elective carryover basis option, is discussed below.⁹²

88. At least one commentator has advanced such an argument. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 154.

89. Ronald A. Pearlman, Deputy Assistant Secretary of the Treasury for Tax Policy, made the point well:

The rules of corporate taxation are an integrated whole. If changes are made to certain of the basic provisions—for example, the rule of *General Utilities*—those changes will reverberate throughout the system. Some provisions previously thought necessary to prevent abuse may no longer be relevant; others may have to be redrawn and strengthened. Accordingly, we believe that a fundamental restructuring must take into account all collateral consequences.

Finance Hearings on Reform of Corporate Tax, *supra* note 87, at 28.

90. ALI Proposals, *supra* note 11, at 12, 104, 111-16. Although the ALI Proposals contemplate the possibility of partial integration of corporate and individual income taxes by means of a shareholder credit based on the income tax paid by the corporation, Professor Alvin Warren points out that the proposals really involve "refinement of the corporate tax as an additional levy on corporate profits." Warren, *supra* note 87, at 720. Professor Warren's article refers to the ALI FEDERAL INCOME TAX PROJECT, SUBCHAPTER C—CORPORATE DISTRIBUTIONS (Tent. Draft No. 2, 1979), but the Tentative Draft and the ALI Proposals adopt the same philosophy of corporate taxation.

91. STAFF REPORT, *supra* note 11, at 4, 88-93. Although the Staff Report states that the staff of the Senate Committee on Finance made no judgment as to the propriety of the corporate level tax, the Staff Report clearly contemplates that the corporate level tax should result in double taxation.

92. For purposes of considering whether the liquidation nonrecognition provisions should be repealed, this Article assumes that the corporate income tax will continue as a separate tax. The threshold question of whether we should have a separate corporate in-

The problem of the stepped-up basis with no corresponding tax liability involves an ancillary issue. If accrued gain is to be subjected to taxation before a step-up in basis will be permitted, is the liquidating corporation, in all cases, the appropriate taxpayer? This issue raises the general problem of the proper role of the corporate income tax in our federal income tax system.⁹³ Both the ALI Proposals⁹⁴ and the Staff Report⁹⁵ contemplate strengthening the corporate income tax and would, therefore, require the liquidating corporation to recognize the gain in all cases. This approach would mean increased double taxation. To the extent that this change would impose a double tax on inflation-created gain, some commentators have argued that the result of strengthening the corporate income tax would be the creation of an unreasonable tax burden.⁹⁶ While concern about the role that the corporate income tax plays in the equitable distribution of the overall federal income tax burden is appropriate,⁹⁷ resolution of this issue can be based on arguments that have been thoroughly set forth in existing works.⁹⁸ Although the following discussion involves a consideration of the extent to which the existing system of double taxation should be strengthened, the focus of the discussion is the most appropriate way to resolve the stepped-up basis problem.

2. *Simplification of Subchapter C*

Proponents of repeal of sections 336 and 337 contend that repeal will simplify Subchapter C in the following ways: (1) by eliminating the need for the collapsible corporation rules embodied in section 341;⁹⁹ (2) by eliminating the need to satisfy the often complex requirements of sections

come tax has been debated for years with no conclusive result. See G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM?* 90-104 (1975); R. GOODE, *THE CORPORATION INCOME TAX* 24-43 (1951); Bird, *Why Tax Corporations?*, in *TAXING CORPORATIONS* 9 (Institute for Research on Public Policy 1980); Warren, *supra* note 87, at 798. Although most public finance economists agree that in an ideal tax system a separate corporate income tax has no place, see R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 408 (3d ed. 1980), the United States has since 1909 had a separate corporate income tax. The separate corporate income tax probably will not be repealed in the near future. For a summary of the arguments in support of a corporate income tax, see Bird, *supra*, at 12-20.

93. See authorities cited *supra* note 92.

94. See *supra* note 90.

95. See *supra* note 91.

96. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 153-57 (statement of John S. Nolan).

97. A study done by the Joint Committee on Taxation and the General Accounting Office indicates that the portion of the overall United States tax burden borne by corporations declined from 28.3% in 1950 to 11.5% in 1981 and 8.1% in 1982. During that same period, personal income taxes as a percentage of total federal tax receipts increased from 39.2% in 1950 to 49% in 1982. Staff of the Joint Committee on Taxation and the General Accounting Office, "Study of the 1982 Effective Tax Rates of Selected Large U.S. Corporations," reproduced in TAX NOTES MICROFICHE DATABASE Doc. No. 83-11145.

98. See authorities cited *supra* note 92.

99. I.R.C. § 341 (1982), as amended by Tax Reform Act of 1984; see STAFF REPORT, *supra* note 11, at 89.

336 and 337 and the antiselectivity rules of section 338;¹⁰⁰ (3) by limiting liquidation-reincorporation transactions, thereby simplifying a body of judicially created Subchapter C rules;¹⁰¹ and (4) by allowing less attention to be focused on the judicially created tax benefit rule, the clear reflection of income rule, and the assignment of income rule.¹⁰²

Would repeal of sections 336 and 337 simplify Subchapter C by eliminating the need for the collapsible corporation provision, section 341? Section 341, which first appeared in 1950 as section 117(m)¹⁰³ of the 1939 Code, was enacted to curb an abuse made possible by the liquidation nonrecognition rule, which was then embodied in the Regulations. A collapsible corporation is a tax avoidance device that, in its simplest form, operates in the following manner. A corporation is formed for the purpose of producing or acquiring an asset, such as a motion picture, which upon sale or exploitation produces ordinary income. Just before the corporation begins to realize the ordinary income, the corporation is liquidated, and the asset is distributed to the shareholder. The nonrecognition rule, now embodied in section 336(a), protects the corporation from being taxed on the appreciation in the value of the asset. As to the shareholder, section 331 treats the liquidation as a sale or exchange of the shareholder's stock. The shareholder, therefore, takes a basis in the asset equal to its fair market value on the date of distribution,¹⁰⁴ and the only income tax cost is long-term capital gain to the shareholder.¹⁰⁵ Without section 341, the collapsible corporation device permits transformation of corporate-level ordinary income into long-term capital gain in the shareholder's hands. Section 341 operates to transform this potential long-term capital gain to the shareholder into ordinary income.¹⁰⁶ Proponents of repeal argue that repeal of the liquidation nonrecognition rules would eliminate the collapsible corporation device because the corporation would always have to recognize gain when removing assets from corporate solution. Since the device will not work without the liquidation nonrecognition provisions, Congress could repeal section 341.

If the inquiry stops at this point, one might conclude that repeal of the liquidation nonrecognition rules would accomplish a major simplification of Subchapter C. Section 341 is certainly one of the most complicated sections of Subchapter C and often serves as a trap for the unwary tax-

100. ALL PROPOSALS, *supra* note 11, at 111; STAFF REPORT, *supra* note 11, at 34-36, 88-89.

101. *Id.* at 37-38, 90-91.

102. *See id.* at 36.

103. Revenue Act of 1950, Pub. L. No. 81-814, § 212, 64 Stat. 906, 934.

104. I.R.C. § 334(b)(1) (1982).

105. *Id.* § 331(a).

106. Section 341 does not cause corporate recognition of gain in this hypothetical, but only transforms *shareholder's* gain into ordinary income. Congress could have elected to tax the corporation and the shareholder in such a situation, but did not choose to do so. Section 341 does result in corporate recognition if a collapsible corporation sells assets rather than distributes assets in-kind. *See* I.R.C. § 337(c)(1)(A) (1982).

payer.¹⁰⁷ Nonetheless, two points should be considered before repeal is embraced on that basis. First, the Staff Report states that the collapsible corporation rules could not be repealed for foreign corporations, because corporate-level gain is generally not taxed on the liquidation of a foreign corporation.¹⁰⁸ Second, an argument can be made that repeal of the liquidation nonrecognition rules would not eliminate the need for section 341, at least for the sort of protection against abuse that section 341 now provides.¹⁰⁹ For example, a person in the business of selling unimproved land could form a corporation to hold the real estate. The shareholder could, by waiting for one year and a day, sell the stock of the corporation and recognize only long-term capital gain on the sale of the stock. The purchaser of the stock, having effective control of the land through control of the corporation, might well elect to continue to hold the land through the corporation. The purchaser of the stock could thus defer the corporate-level tax on the appreciation in value of the land until the corporation either sold the land or liquidated. The value of such tax deferral is obvious.¹¹⁰ While the Internal Revenue Service might devise a theory on which to attack this sort of abuse,¹¹¹ section 341, if it were still in force, would minimize such abuse because the section extends to sales of stock as well as to actual liquidations.¹¹²

Even if one accepts the argument that repeal of sections 336 and 337 would permit the repeal of section 341 as it applies to all domestic corporations, the repeal of sections 336 and 337 may exchange an existing complex provision for a new complex provision. Outright repeal of sections 336 and 337, without temporary or permanent relief provisions, would not create new complexity. Such simplifications, however, would result in double taxation. For that reason, comment¹¹³ on the Staff Report suggests mitigation of this double taxation either by temporary relief,¹¹⁴ permanent relief,¹¹⁵ or both. If temporary or permanent relief is adopted, the provisions implementing such relief could be very complicated.¹¹⁶ Thus, repeal of the

107. See Ginsburg, *Collapsible Corporations—Revisiting an Old Misfortune*, 33 TAX L. REV. 307 (1978).

108. STAFF REPORT, *supra* note 11, at 89.

109. See Letter from J. Roger Mentz to Roderick A. DeArment, Chief Counsel, Committee on Finance at 3-4 (Oct. 27, 1983), reproduced in TAX NOTES MICROFICHE DATABASE Doc. No. 83-10848.

110. See W. ANDREWS, BASIC FEDERAL INCOME TAXATION 206-10 (2d ed. 1979).

111. The Internal Revenue Service might be able to argue that the seller held the stock of the corporation primarily for sale to customers in the ordinary course of the seller's business. The success of such an argument would by no means be assured.

112. I.R.C. § 341(b)(1) (1982), as amended by Tax Reform Act of 1984.

113. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 83 (statement of Edward N. Delaney); *id.* at 100 (New York Bar State Association Tax Section); *id.* at 115 (statement of Frank V. Battle, Jr.); *id.* at 137 (statement of Robert A. Jacobs).

114. Temporary relief might take the form of a phase-in of the tax on capital gains recognized by the corporation as a result of repeal.

115. Permanent relief might take the form of shareholder tax credits based on the corporate level tax, or of exemption of certain assets or transactions from taxation.

116. For a discussion of possible transitional rules and permanent relief rules, see *infra* text at notes 166-93.

liquidation nonrecognition provisions will not necessarily result in overall simplification of Subchapter C.

Would repeal eliminate the need for the rigid and formal rules of section 336 and 337 and for the complex antiselectivity rules of section 338? Clearly, repeal of the liquidation nonrecognition provisions would, with a single stroke of the legislative scalpel, remove from the 1954 Code the provisions that create what the ALI Proposals refer to as "substantial continuing problems about what constitutes compliance with the formal and ritual requirements of sections 336 and 337."¹¹⁷ Repeal of the liquidation nonrecognition provisions, however, may not eliminate the need for the antiselectivity provisions of section 338,¹¹⁸ because Congress's reason for including the antiselectivity provisions in section 338 is unclear.

Prior to the enactment of the mergers and acquisitions provisions of TEFRA,¹¹⁹ a corporation (acquiring corporation) could structure the acquisition of another corporation (target corporation) to obtain a stepped-up cost basis in some of the assets of the target corporation while retaining a carryover basis in the remaining assets of the target corporation. This selective basis step-up was achieved by using a combination of the pre-TEFRA partial liquidation rules¹²⁰ and the consolidated reporting rules.¹²¹ The assets that were to receive a stepped-up basis would be distributed to the acquiring corporation in a partial liquidation. The target corporation would recognize no gain because, prior to TEFRA, section 336 applied to partial liquidations as well as to complete liquidations¹²² and the consolidated return provisions permitted deferral of the tax on recapture gains. The acquiring corporation would recognize long-term capital gain as a result of the partial liquidation distribution,¹²³ and the assets would have a basis, in the hands of the acquiring corporation, equal to their fair market value on the date of distribution.¹²⁴ The remaining assets of the target corporation would retain their historical basis in the hands of the target corporation. The acquiring corporation would have the additional benefit of using the target corporation's tax attributes by means of filing consolidated returns. The drafters of the Corporate Takeover Tax Act of 1982,¹²⁵ which contained the initial version of the provisions that Congress ultimately enacted as section 338, believed that the opportunity presented by the foregoing hypothetical provided an incentive for corporate acquisitions.¹²⁶ The drafters, however, did not indicate whether they

117. ALI PROPOSALS, *supra* note 11, at 111.

118. The antiselectivity provisions of § 338 are set forth in I.R.C. §§ 338(e) & (f) (1982).

119. TEFRA §§ 222-228.

120. I.R.C. § 336(a) (Supp. V 1981), *amended by* TEFRA § 222(b); I.R.C. § 346(a)(2) (Supp. V 1981), *amended by* TEFRA, § 222(d).

121. I.R.C. §§ 1501-1505, 1551-1552, 1561-1564 (Supp. V. 1981).

122. *See supra* note 5.

123. I.R.C. § 331(a)(2) (Supp. V 1981), *amended by* TEFRA, § 222(a).

124. I.R.C. § 334(a) (Supp. V 1981), *amended by* TEFRA, § 222(e)(1)(C).

125. *See supra* note 9.

126. *See* Floor Statement of Rep. Fortney Stark on H.R. 6295, The Corporate Takeover Tax Act of 1982, at 2, *reproduced in* TAX NOTES MICROFICHE DATABASE Doc. No. 82-5408.

perceived the problem as merely the opportunity to select some assets for a step-up in basis while taking other assets with a carryover basis, or as the opportunity to obtain a stepped-up basis without recognition of gain by the distributing corporation.

If the problem that the antiselectivity provisions seek to resolve is the ability to pick and choose among assets, then repeal of the liquidation nonrecognition provisions would not eliminate the problem. Selectivity would still be possible, albeit at a somewhat greater tax cost to the distributing corporation than if the liquidation nonrecognition provisions were in force. If, however, the problem that prompted the enactment of the antiselectivity provisions was the ability to obtain a stepped-up basis without recognition of gain by the distributing corporation, repeal of the liquidation nonrecognition provisions would eliminate the need for the antiselectivity provisions. The antiselectivity provisions may still be needed though, if repeal is accompanied by enactment of any provisions granting relief from repeal. For example, if certain assets are exempted from recognition, some sort of antiselectivity provisions would still be required.¹²⁷ Thus, once again, repeal of the liquidation nonrecognition provisions would not ensure overall simplification of Subchapter C.¹²⁸

Would repeal limit liquidation-reincorporation transactions? The Staff Report argues that the *General Utilities* rule has encouraged liquidation-reincorporation transactions because of the opportunity, created by the rule, to bail out earnings and profits at capital gains rates and to step up the basis of depreciable assets at the cost of recapture gain to the liquidating corporation and capital gain to the shareholders.¹²⁹ The Staff Report contends that the mixed success of the government in litigating the validity of such transactions has caused "substantial uncertainty and complexity, and significant opportunity for abuse."¹³⁰ While repeal of the liquidation nonrecognition provisions would clearly discourage the use of the liquidation-reincorporation device as a means of obtaining a stepped-up asset basis at relatively small tax cost, the device may continue to be used for bailing out earnings and profits at capital gain rates. Although repeal of the liquidation nonrecognition provisions would increase the tax cost of such bail out, the bail out would still work because the shareholder would still receive what should have been dividend income, taxable at ordinary income rates, as long-term capital gain.¹³¹ If taxpayers continue to use the liquidation-reincorporation device, the government would, presumably, continue to litigate the issue, with, presumably, no substantial change in

127. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 26 (statement of Ronald A. Pearlman).

128. Significantly, the Staff Report, referring to the anti-selectivity rules of § 338, provides: "Thus, despite the merits of the restrictions the Congress sought to enact last year, it is not clear that the statute provides an effective statutory solution; moreover, it is not even clear that such a solution can be devised." STAFF REPORT, *supra* note 11, at 35-36.

129. *Id.* at 37.

130. *Id.*

131. For a proposed solution to the bail-out problem, see Honabach, *Taxing the Corporate Liquidation—A Proposal for Consistency*, 8 J. CORP. L. 1, 21-28 (1982).

the present uncertainty and complexity that concerns the staff.¹³²

Would repeal allow less attention to be focused on the application of the tax benefit rule, the clear reflection of income rule, and the assignment of income rule in the context of corporate liquidations? The Staff Report suggests that repeal of the liquidation nonrecognition provisions would eliminate much of the complexity created by the application of these rules to liquidations. The theory espoused by the staff is, apparently, that recognition of gain at the corporate level would obviate the need for such rules.¹³³ The Staff Report seems, however, to overlook two important points. First, if certain relief provisions exempt from taxation gain from certain assets of certain transactions, these rules might still be needed to ensure a proper tax result. Second, and perhaps most importantly, the cases cited by the Staff Report on this point all dealt with questions of timing and of determination of the proper taxpayer, not with the interaction of the three rules with the liquidation nonrecognition provisions.¹³⁴ All three rules would continue to apply to corporate liquidation even after repeal of sections 336 and 337.¹³⁵ The tax benefit rule would continue to apply because, as the Supreme Court held in *Hillsboro National Bank v. Commissioner*,¹³⁶ the tax benefit rule applies whenever "events occur that are fundamentally inconsistent with an earlier deduction."¹³⁷ The clear reflection of income and assignment of income rules would continue to apply because these rules address questions of whether the liquidating corporation or the shareholders should be charged with receipt of certain income. The issue is not recognition, but rather identification of the proper taxpayer. Repeal of the liquidation nonrecognition provisions, therefore, should not greatly decrease the use of these three rules in the context of corporate liquidations.

3. Tax Neutrality

A criterion of sound tax policy is that the tax law should reduce to the minimum the intrusion of the tax into household and business decisions concerning the amount of income to earn, the way to earn income, and how to use income and wealth.¹³⁸ The assumption is that in a free market economy without income tax, private economic decisions would direct resources into their most profitable uses. Of course, no system of taxation

132. One commentator has argued that the Staff Report greatly overstates the problem of the liquidation-reincorporation problem. *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 165 (statement of John S. Nolan).

133. See STAFF REPORT, *supra* note 11, at 36.

134. *Id.*

135. Committee on Taxation, Association of the Bar of the City of New York, Comments with Respect to the Staff Report at 21-22 (Nov. 2, 1983), reproduced in TAX NOTES MICROFICHE DATABASE Doc. No. 83-11125.

136. 103 S. Ct. 1134, 75 L. Ed. 2d 130 (1983).

137. *Id.* at 1138, 75 L. Ed. 2d at 139.

138. Ture, *Federal Income Tax Rates, Incentives, and Equities*, in ESSAYS ON TAXATION 24 (1974).

will ever attain complete neutrality.¹³⁹ Our system of income taxation presents many examples of provisions that are intended to encourage¹⁴⁰ or discourage¹⁴¹ specific decisions concerning the earning and use of income. Indeed, our income tax law clearly operates as a major instrument of social and economic policy.¹⁴² Notwithstanding the fact that any income tax system, including our own, will affect economic decisions to some degree, a neutral tax system should affect economic decisions to the least extent possible.

Application of the criterion of tax neutrality to Subchapter C is difficult because the present separate corporate income tax influences decisions to use the corporate vehicle for conducting a business enterprise. This influence is particularly strong for corporations that are not eligible to avoid imposition of the corporate level tax by utilizing the provisions of Subchapter S.¹⁴³ As noted earlier, however, our system has been, in practice if not in theory, a compromise involving double taxation of earnings from normal business operations and single taxation at the shareholder level of extraordinary events such as liquidations. Whatever effect the existence of the present separate corporate income tax has on decisions to do business in corporate form, the principle of tax neutrality cannot be discarded when considering reform of Subchapter C. An examination of any reform proposals is necessary to determine whether such proposals would reduce the intrusion of the corporate income tax law into decisions affecting business operations.¹⁴⁴

Proponents of repeal of the liquidation nonrecognition provisions argue that the existence of these provisions makes Subchapter C less tax-neutral than it would be without those provisions. The Staff Report, however, recognizes that the neutrality problem arises not solely because of the liquidation nonrecognition provisions, but rather because of the combination of the liquidation nonrecognition provisions and the liquidation basis provisions.¹⁴⁵ The Staff Report contends that the ability to combine these provisions, thereby obtaining a stepped-up basis in corporate assets without incurring any corresponding tax on the appreciated value of the assets, is enough of an incentive for mergers that otherwise would not have oc-

139. "[N]o income tax can be completely neutral since it increases the price of income generating activities relative to leisure." *Id.* at 25.

140. See, e.g., I.R.C. § 38 (1982), as amended by Tax Reform Act of 1984 (Investment Tax Credit); I.R.C. § 168 (1982), as amended by Tax Reform Act of 1984 (Accelerated Cost Recovery); I.R.C. § 170 (1982), as amended by Tax Reform Act of 1984 (Charitable Contributions Deduction); I.R.C. § 1202 (1982) (Deduction for Capital Gains).

141. See, e.g., I.R.C. §§ 531-37 (1982), as amended by Tax Reform Act of 1984 (Improper Accumulations); I.R.C. §§ 541-547 (1982), as amended by Tax Reform Act of 1984 (Personal Holding Companies).

142. See J. PECHMAN, *FEDERAL TAX POLICY* 5 (3d ed. 1977).

143. Subchapter S of the 1954 Code is comprised of §§ 1361-1379.

144. The key word in this context is "reduce," because complete neutrality would be neither possible nor desirable. For example, in order to prevent abuse of the corporate form to gain improper tax benefits, the tax law would have to include provisions such as I.R.C. § 269A (1982) (personal service corporations formed or availed of to avoid or evade income tax), that would discourage the use of the corporate form under certain circumstances.

145. STAFF REPORT, *supra* note 11, at 89-90.

curred.¹⁴⁶ Although some commentators have disagreed with the staff's conclusion that the liquidation nonrecognition provisions cause mergers,¹⁴⁷ arguably, the Staff Report does identify a key tax neutrality problem.

The ALI Proposals also discuss the tax neutrality issue in connection with the proposed repeal of the liquidation nonrecognition provisions. The ALI Proposals note two instances of lack of tax neutrality. First, the liquidation nonrecognition provisions create "too large a discrepancy in favor of selling out or distribution as compared with continuation in business."¹⁴⁸ The discrepancy exists not just because of the lack of a corporate level tax imposed upon liquidation, but because the shareholders in a section 336 liquidation or the purchasers in a section 337 liquidation get a stepped-up basis in the corporate assets without the imposition of any corresponding tax on the appreciation in value of those assets. Second, the liquidation nonrecognition provisions are "out of harmony with the treatment of an unincorporated proprietor"¹⁴⁹ because a liquidating corporation recognizes gain on the bulk sale or distribution of inventory only to the extent of recapture of the LIFO benefit,¹⁵⁰ whereas an unincorporated proprietor must recognize all gain generated by the bulk sale of inventory. Similarly, while the unincorporated cash basis proprietor must recognize ordinary income on amounts allocated to accounts receivable, the cash basis corporation that liquidates is ordinarily not required to recognize income on sale or distribution of its accounts receivable. Although the ALI Proposals do identify two neutrality problems, unfortunately the discussion of these problems focuses on the failure to impose a tax on the distributing corporation, rather than on the problem of the opportunity, under present law, to obtain a stepped-up asset basis without payment of any corresponding tax.

The tax neutrality problems raised in the Staff Report and in the ALI Proposals are valid problems. Nevertheless, complete repeal of the liquidation nonrecognition provisions is not necessarily the best way of dealing with these problems, even though complete repeal is certainly the simplest response to the problem of the unjustified increase in asset basis. That latter problem is avoidable, however, by retaining the liquidation nonrecognition provisions, but requiring the distributees to take a carryover basis in the corporate assets. Such an approach prevents a step-up in basis without a tax on the appreciation in the value of the assets, but also shifts the tax from the liquidating corporation to the distributees and defers the tax until the distributees dispose of the property in a taxable transaction. Such shifting and deferral would not be appropriate in all situations. A repeal

146. *Id.*

147. *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 164. For a general discussion of this issue prepared before the Staff Report was issued, see A. FELD & D. TERKLA, *TAX POLICY AND INDUSTRIAL CONCENTRATION* 66 (1980).

148. ALI PROPOSALS, *supra* note 11, at 112.

149. *Id.* at 114.

150. I.R.C. §§ 337(b)(2), 337(f) (1982).

of the liquidation nonrecognition provisions would prevent shifting and deferral, but would create hardships in certain circumstances. An appropriate response to the tax neutrality problems must take into account the fact that corporations liquidate for different reasons. Most liquidations involve closely held corporations, rather than publicly held corporations, and are undertaken because: (1) the owners wish to continue the business in unincorporated form; (2) the owners wish to sell the business; or (3) the owners wish to terminate the business. The appropriate tax treatment of liquidations motivated by each of these reasons must be considered separately.

Liquidations that reflect the decision of the owners to continue a business in unincorporated form present no compelling reason to require recognition of gain or loss by the liquidating corporation. The Staff Report contemplates repeal of the liquidation nonrecognition provisions, but that section 351 would be left in place. The rationale for the nonrecognition of gain or loss upon incorporation is that a mere change in the form of a business operation or, in the case of a new business, the initial choice of operating form is not an appropriate taxable event. If incorporation were a taxable event, taxpayers might not elect to incorporate their businesses. The rationale behind section 351 is consistent with the principle of tax neutrality that tax law should affect economic decisions as little as possible. The same rationale applies when the decision is made to switch from incorporated to unincorporated form. In general, the federal income tax should not hinder either the decision to incorporate or the decision to continue a business in unincorporated form.

If the owners of a corporate business wish to continue the business in noncorporate form, Congress can prevent the problem of the stepped-up asset basis without any corresponding tax by requiring the shareholders to take a carryover basis in the distributed assets. The corporation might be allowed to elect gain recognition upon distribution of its assets, in which case the shareholders would take a basis in the assets equal to their fair market value on the date of distribution. Permitting the corporation to treat the liquidation as a nonrecognition event¹⁵¹ would shift the tax on the appreciation in value of the assets to the shareholders and would permit deferral of the tax until the shareholders subsequently disposed of the assets in a taxable transaction. While the opportunity to shift and defer tax liability could result in some taxpayer abuse, as section 351 now recognizes, shifting and deferral are appropriate because immediate taxation improperly affects decisions relating to the form in which a business is conducted.

In contrast, liquidations that reflect the decision of the owners to sell the corporate business by selling its assets should be taxable events. The sale of the assets presents an appropriate time to require recognition of gain or

151. The election to treat the liquidation as a nonrecognition event would be subject to all recapture requirements, both statutory and judicial, that currently apply to liquidations under § 336.

loss by the liquidating corporation. The present rule of corporate nonrecognition is inconsistent with the tax treatment of individuals and partnerships, for whom asset sales are taxable events. Further, the liquidation nonrecognition provisions create distortions in the allocation of the purchase price paid for corporate assets. For example, because a liquidating corporation does not recognize gain when it sells its inventory in bulk as a part of section 337 liquidation, such a sale may cause an excessive allocation of purchase price to inventory.¹⁵² Section 337(f), which is effective for plans of liquidation adopted after December 31, 1982,¹⁵³ responds to this problem to an extent by requiring that the liquidating corporation recapture any tax benefit that it realized from using the LIFO inventory method.¹⁵⁴ Section 337(f) does not, however, wholly resolve the problem because unreaptured inventory gain is still protected by the nonrecognition provisions. Since the purchaser receives a cost basis in the inventory, a significant portion of what should have been taxed as ordinary income will in effect escape taxation entirely.¹⁵⁵

Making this type of liquidation a taxable event could cause some taxpayers to avoid asset sale liquidations by resorting to mergers that would satisfy the requirements of the Code's taxfree reorganization provisions. Eliminating tax-motivated mergers is a stated goal of the Staff Report,¹⁵⁶ yet repeal of the liquidation nonrecognition provisions could actually increase certain types of merger activity. For that reason, some commentators have argued that repeal would violate the principle of tax neutrality.¹⁵⁷ They point out that if a corporate business is disposed of by tax-free reorganization, the shareholders of the acquired corporation must maintain an investment in the acquiring corporation. Thus, by engaging in tax-free reorganization in order to avoid corporate-level taxation, the shareholders are not free to reinvest the proceeds of the "sale" in a new venture. This intrusion of the tax system into economic decision-making must, however, be weighed against the fact that the tax-free reorganization provisions do not permit a stepped-up asset basis until gain is recognized. Depending upon the type of tax-free reorganization used, the acquired corporation may shift the tax to the acquiring corporation. Although the reorganization nonrecognition rules permit the acquiring corporation to defer recognition of the tax, the gain ultimately will be taxed. For that reason, repeal of the liquidation nonrecognition provisions for liquidations

152. ALI PROPOSALS, *supra* note 11, at 112-13.

153. Miscellaneous Revenue Act of 1982, Pub. L. No. 97-362, § 101, 96 Stat. 1726.

154. I.R.C. § 337(f) (1982) requires recapture of the "LIFO Recapture Amount." The term "LIFO Recapture Amount" is defined in I.R.C. §.336(b)(3) (1982) as the amount, if any, by which the value of inventory assets determined under the first-in, first-out method exceeds the value of those assets determined under the last-in, first-out method.

155. Although the shareholders of a liquidating corporation recognize gain upon receipt of the liquidating distribution, that gain, as the ALI Proposals point out, is long-term capital gain. The relationship of that gain to the untaxed inventory gain and other untaxed corporate level gain is purely fortuitous. ALI PROPOSALS, *supra* note 11, at 112.

156. STAFF REPORT, *supra* note 11, at 89.

157. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 151.

that reflect a decision to sell the corporate business would not create a serious tax neutrality problem.

Liquidations that reflect the decision of the owners to terminate the corporate business without selling the assets to a third party present a difficult problem in terms of tax neutrality. The continuity of business ownership, which would justify nonrecognition when the business is continued by the owners after the corporate form is abandoned, does not exist when the business is terminated. On the other hand, the assets have not been sold, so that hardship may result if a corporate-level tax is imposed. Such hardship might cause continuation of a business that the owners otherwise would terminate. One approach to this type of liquidation allows a corporate election. The corporation could either treat the liquidation as a taxable event, with the result that the shareholders would take a stepped-up basis in the assets, or as a nonrecognition event, in which case the shareholders would take a carryover basis.¹⁵⁸

As the foregoing discussion indicates, the liquidation nonrecognition provisions, in combination with the liquidation basis provisions, create tax neutrality problems. If these problems are addressed by repealing the liquidation nonrecognition provisions, a new tax neutrality problem may arise. To the extent that gain on corporate assets is the result of inflation, a liquidation decision must include consideration of the amount of the double tax on such gain. Even if such assets generate long-term capital gain, double taxation of inflation-created capital gain would, under the present rate structure, produce a harsh result. For example, Corporation *C*, which has a capital asset with a fair market value of \$20,000 and a basis to *C* of \$10,000, adopts a plan of liquidation that calls for the sale of the asset to a third party and the distribution of the proceeds of the sale to *C*'s sole stockholder, *S*. If section 337 is repealed, *C* would have to pay a tax on the \$10,000 long-term capital gain of \$2,800.¹⁵⁹ *C* would then distribute the net proceeds, \$7,200, to *S*. If *S* is in the 50% tax bracket, *S* will pay a tax of \$1,440 on the distribution.¹⁶⁰ The total income tax imposed on the \$10,000 of long-term capital gain would be \$4,240, which results in an effective tax rate of 42.4%. To the extent that this tax rate is applied to inflation-created gain, the amount of tax might militate against liquidation. Such a problem would be particularly acute for closely held family corporations that have been in existence for many years.

A related problem that repeal of the liquidation nonrecognition provisions could cause involves the taxation of preincorporation gains. Section 351 provides that, as a general rule, accrued appreciation will not be recognized when property is transferred to a newly formed corporation. The transfer, therefore, may include substantial preincorporation gain, much of

158. Some provisions would be necessary to prevent abuse in the form of a purported termination liquidation followed by a prearranged sale of assets.

159. This tax is based on the corporate capital gains rate of 28%. I.R.C. § 1201(a) (1982).

160. The \$7,200 would be long-term capital gain to the shareholder. Applying the § 1202(a) net capital gain deduction of 60%, \$2,880 (40%) of the \$7,200 distributed is subject to tax at the 50% marginal rate. The resulting tax would be \$1,440.

which might be inflation-created. Although the constitution does not bar taxing the corporation on preincorporation gain,¹⁶¹ the resulting double tax could be imposed largely on inflation-created gain. If a corporation that is not liquidating sells an asset that has substantial preincorporation gain, the corporation must recognize all of the gain, but the corporation can avoid double taxation by not distributing the proceeds of the sale. The liquidating corporation has no such option.

Many factors enter into the decision to liquidate. The extent to which the double tax on inflation-created gain would affect the decision to liquidate is not clear. In addition, the problem of the appropriate response of our income tax system to inflation-created gain extends beyond the area of corporate liquidations. Nonetheless, if the imposition of a double tax on such gain might lock some existing corporate businesses in corporate form, or if the prospect of a double tax on such gain might deter businesses from incorporating, Congress should take those possibilities into account as it considers the liquidation nonrecognition provisions.

To this point, the discussion has centered on the issue of tax neutrality in terms of recognition of gain by the liquidating corporation. Complete repeal of the liquidation nonrecognition provisions would, however, also permit the liquidating corporation to recognize accrued losses. Existing law both denies the liquidating corporation the opportunity to use such losses and, by requiring the shareholder to take as a basis the distributed assets' fair market value on the date of distribution, effectively prevents the shareholder from using the losses. Complete repeal would resolve this problem by allowing the liquidating corporation to utilize the losses to offset its income. A problem might arise if the liquidating corporation could elect to treat an in-kind liquidation as a nontaxable event and if the shareholder were required to take a carryover basis in the distributed assets. In such a situation, the liquidating corporation could shift losses that it might not be able to use to its shareholders. A response to this problem is suggested by section 1015, which provides for a carryover basis to a donee subject to the rule that, for purposes of computing loss, the donee must use as his basis in the asset the lesser of either the fair market value on the date of the gift or the donor's basis. If the liquidating corporation elected to treat the liquidation as a nontaxable event, the shareholder could be required to take a carryover basis. For purposes of computing loss on a subsequent disposition of the assets, the shareholder could be required to use the lesser of either the carryover basis or the fair market value on the date of distribution. This approach would discourage liquidations motivated by a desire to shift losses from a corporation to its shareholders.

In summary, the tax neutrality problems associated with the liquidation nonrecognition provisions are not created by those provisions alone. To address the tax neutrality problems by completely repealing the liquidation nonrecognition provisions would resolve some tax neutrality problems

161. See *Taft v. Bowers*, 278 U.S. 470, 482 (1929) (no constitutional impediment to taxing donee on appreciation in value of property while in hands of donor).

while creating others. For existing corporations, complete repeal would impose an added tax cost on the decision to liquidate, without regard to the purpose for the liquidation. Complete repeal would not distinguish between liquidations that reflect a mere change in the form in which a business is conducted and liquidations that mark the sale or termination of a business. As a result, repeal would create a general bias against liquidations. Although such a bias would have the salutary effect of eliminating the existing discrepancy in favor of selling out rather than continuing a business, such a bias could also cause new problems. For example, this bias might force businesses, which once operated efficiently in corporate form but now might be more efficiently operated in noncorporate form, to remain in corporate form. For new businesses and existing businesses considering incorporation, repeal would provide an incentive to avoid incorporation because of the increased tax cost of doing business in corporate form.¹⁶² Such a result would be unfortunate because tax laws should not affect decisions to take advantage of the special nontax protections of doing business in corporate form.

4. *Broadening the Tax Base*

Proponents of repeal of the liquidation nonrecognition provisions argue that repeal will broaden the tax base, thereby benefitting all taxpayers by lowering tax rates.¹⁶³ Several points need to be considered in evaluating this argument. First, implicit in a proposal to broaden the tax base is the expectation that such action would increase tax revenues. Repeal of the liquidation nonrecognition provisions might not result in increased revenues because, faced with the prospect of double taxation, corporations might either refrain from liquidating or engage in tax-free reorganizations. Either result would generate no additional tax revenue.¹⁶⁴ Second, even if the base broadening produces additional revenue, a reduction in tax rates in the near future is not ensured. At a time when the federal budget deficit is at its greatest amount ever in this country's history, broadening of the corporate tax base is unlikely to result in immediate lowering of tax rates. Base broadening is a commendable goal, but the base broadening that would result from repealing the liquidation nonrecognition provisions should not be advanced as a means of immediately reducing the income tax rates.

5. *Mitigation*

Repeal of the liquidation nonrecognition provisions would result in a profound change in the operation of our system of corporate income taxation. Congress, therefore, must consider possible temporary or permanent

162. Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743, 771 (1980).

163. See Ginsberg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171, 319 (1983); STAFF REPORT, *supra* note 11, at 89.

164. See Warren, *supra* note 87, at 719.

relief provisions that would mitigate the effects of repeal. Repeal legislation certainly must include provisions for transactions in progress at the time of repeal. Presumably drafting of such provisions would not pose an insurmountable problem.¹⁶⁵ This Article, therefore, focuses on other temporary or permanent relief provisions that Congress might consider if it elects to repeal the liquidation nonrecognition provisions.

As discussed earlier, the primary impact of repeal would be on closely held corporations. To address that problem, the American Bar Association Section of Taxation has suggested the establishment of a special exception from the corporate level tax for closely held corporations.¹⁶⁶ The ABA Statement suggests defining the term "closely held corporation" as that term is presently defined in the personal holding company provisions of the 1954 Code.¹⁶⁷ The ABA Statement further suggests that the definition should establish a "relatively low maximum asset level" as one criterion for closely held corporation status.¹⁶⁸ The ABA Statement does not elaborate on what would be considered a relatively low asset level. Apparently, however, the ABA Statement is premised on the assumption that only very small corporations, which conduct businesses that could be conducted as sole proprietorships or as partnerships, should receive relief from repeal.¹⁶⁹ Such corporations seldom pay dividends, because they usually can distribute their earnings and profits in the form of salaries that are deductible by the corporations in computing taxable income. By paying salaries, the corporations avoid any double taxation under current law. Thus, the ABA Statement may be endorsing protection of the status quo.

Apart from the fact that the close corporation exception suggested by the ABA Statement does not clearly establish the scope of the exception, the suggestion merits careful scrutiny on two points. First, most if not all of the corporations apparently protected by the exception would also qualify to elect taxation under Subchapter S. Election of Subchapter S would eliminate the problem of double taxation.¹⁷⁰ If sections 336 and 337 were repealed, on liquidation the recognition of gain at the corporate level would increase the gain passed through to the shareholders, but if the approach established by section 1363(d) for nonliquidating distributions of appreciated property is followed, the only tax imposed would be at the shareholder level.¹⁷¹ The close corporation exception would benefit those corporations that could not or did not wish to elect Subchapter S treat-

165. *But see* Pierson, *Lawmaking*, 18 TAX NOTES 659 (Feb. 21, 1983) (discussing problems of drafting and adopting TEFRA).

166. *See Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 90 (statement of Edward N. Delaney, Chairman, Section of Taxation, American Bar Association).

167. *See* I.R.C. § 542(a)(2) (1982).

168. *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 90.

169. *See id.* at 91.

170. Of course, I.R.C. § 1374 (1982), *as amended* by Tax Reform Act of 1984, could impose a corporate level tax on excess capital gains, and I.R.C. § 1375, *as amended* by Tax Reform Act of 1984, could impose a corporate level tax on excess passive investment income.

171. *See* I.R.C. § 331 (1982).

ment. Some corporations falling within the exception suggested in the ABA Statement would not qualify for Subchapter S treatment because they would have, for estate planning purposes, nonqualified trusts as shareholders.¹⁷² Some corporations might not want to elect Subchapter S treatment because the election would eliminate the possibility of accumulating earnings and profits at the corporate level without exposing them to tax at the shareholder level. Nonetheless, Subchapter S provides many small corporations with an existing means of eliminating the double tax burden caused by repeal of the liquidation nonrecognition provisions. Thus, the exception suggested by the ABA Statement would benefit only a very small group of corporations while, as noted below, creating new complexity in Subchapter C.

A second problem raised by the exception suggested by the ABA Statement is that it would create additional complexity in Subchapter C. In the context of Subchapter C, complexity by itself is not automatically a valid objection to a provision. The suggested exception would, however, not only add complexity,¹⁷³ but would also create an opportunity for manipulation. As the ABA Statement points out, such an exception would require an anti-avoidance rule to deal with fragmentation of assets in multiple commonly controlled corporations.¹⁷⁴ In light of the complexity and potential for manipulation, an exception for closely held corporations seems inappropriate.

If we assume that an attempt to except close corporations from the effects of repeal is inappropriate, exempting either certain transactions or certain assets from the effects of repeal might be possible. A possible candidate for a transactional exception would be a complete liquidation done for the purpose of shifting from incorporated to unincorporated form. As discussed earlier, if the rationale for nonrecognition at the time of incorporation is correct, the same rationale should apply to a liquidation done solely for the purpose of continuing the same business with the same assets in unincorporated form. If such an exception were created, the price for corporate nonrecognition upon liquidation, like the price for nonrecognition upon incorporation, should be that the shareholders would take a carryover basis in the distributed assets. The carryover basis would be necessary to avoid the collapsible corporation problem.¹⁷⁵

The exception for in-kind liquidations, which are part of a mere change in the form in which a business is conducted, presents significant problems, despite its attractiveness. First, although recapture generally does not occur upon incorporation,¹⁷⁶ recapture should apply upon liquidation. Since

172. See *id.* § 1361(c)(2), (d) (1982), as amended by Tax Reform Act of 1984 (descriptions of qualified trusts).

173. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 90 n.4 (ABA statement).

174. *Id.*

175. ALI PROPOSALS, *supra* note 11, at 114-15.

176. See I.R.C. §§ 1245(b)(3), 1250(d)(3) (1982) (exempting tax-free contributions upon incorporation from recapture rules).

the corporation benefitted from the depreciation deductions, the corporation should bear the burden of recapture upon liquidation. To the extent that the corporation took advantage of more depreciation than was justified by the actual economic condition of its assets, recapture is appropriate. Similarly, the tax benefit rule and the assignment of income rules should apply notwithstanding such an exception. Second, if such liquidations are exempted from recognition, provisions would have to be implemented to prevent shareholders from immediately engaging in prearranged asset sales following in-kind liquidations. This abuse would revive the problems illustrated by the United States Supreme Court decisions in *Commission v. Court Holding Co.*¹⁷⁷ and *United States v. Cumberland Public Service Co.*¹⁷⁸ Making corporate nonrecognition contingent on continuation of the former corporate business for a substantial period of time, perhaps one year, affords a possible solution to this problem. Such a solution would introduce an element of complexity, but the 1954 Code contains precedent for this type of approach.¹⁷⁹

Instead of creating an exception for in-kind liquidations, Congress might consider creating exceptions for certain assets distributed by a liquidating corporation. One possibility involves excepting gain on assets held for an extended period of time from recognition at the corporate level. The rationale for such an exception would be that the gain on such assets is largely attributable to inflation and should not be subjected to double taxation even at favorable capital gains rates.¹⁸⁰ Proponents of such an exception emphasize this rationale.¹⁸¹ The Staff Report, on the other hand, rejects such an exception precisely because the exception avoids double taxation.¹⁸²

The adoption of such an exception would raise questions regarding the type of assets to cover and their related holding periods. As to the former question, capital assets and section 1231 assets seem to be the appropriate candidates for coverage.¹⁸³ The exception should not cover assets, such as inventory, that produce ordinary income, even though they are subject to inflation. Such assets generally turn over regularly enough to avoid the problems of serious inflation-created gains. As to the latter question, one proponent of the exception has suggested a period of between three to five

177. 324 U.S. 331 (1945) (immediate sale by shareholders of a property in a liquidating dividend deemed essentially a sale by corporation).

178. 338 U.S. 451 (1950) (court not required to find that shareholder's immediate sale of assets gained in liquidating distribution constituted a sale by distributing corporation).

179. See I.R.C. § 302(c) (1982) (granting complete redemption treatment upon conditions set forth therein).

180. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 148-49 (statement of John S. Nolan).

181. See *id.* at 118 (statement of Frank V. Battle, Jr., Chairman, Special Committee on Subchapter C Legislation, Chicago Bar Association); *id.* at 142 (statement of Robert A. Jacobs).

182. STAFF REPORT, *supra* note 11, at 93.

183. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 273-76 (statement of James M. Roche); *id.* at 142 (statement of Robert A. Jacobs).

years as an appropriate holding period.¹⁸⁴ The reason for this suggestion is not clear. Although the long-term capital gain holding period is presently one year,¹⁸⁵ proponents apparently believe that a longer period is required to justify the exception to the liquidation recognition rules. The longer period would help to ensure that the gain being protected is in fact inflation-created. On the other hand, any holding period is selected on an essentially arbitrary basis and would not reflect changes in the rate of inflation. For that reason, an exception for assets held for a long period of time is not very attractive.

One point that proponents of such an exception have not addressed is the method of calculating a holding period. For example, should a corporation be permitted to tack the holding period of a transferor of the property who transferred the property to the corporation under section 351? For purposes of determining gain or loss on the disposition of such an asset, a corporation is presently permitted to tack the holding period of the transferor.¹⁸⁶ If the purpose of the exception is to minimize the effects of the double tax on inflation-created gain, tacking would seem appropriate. Tacking would permit manipulation, however, if on liquidation the shareholder received a stepped-up basis in the asset. In such a situation, a shareholder could transfer a long-held, low-basis asset to a controlled corporation, then liquidate the corporation and get the asset back with a stepped-up basis without the imposition of any corporate income tax. That problem could, however, be avoided by requiring that such assets take a carryover basis in the hands of the shareholder.

This Article has to this point examined proposals that would mitigate the effects of repeal of the liquidation nonrecognition provisions by excepting certain transactions or assets from recognition. A conceptually different approach to mitigation of the effects of repeal would be to repeal the liquidation nonrecognition provisions entirely, but provide temporary or permanent relief from the double taxation created by repeal. As a possible approach to mitigation, the Staff Report suggested phasing in the corporate capital gains tax.¹⁸⁷ As proposed by the Staff Report, the phase-in would be accomplished over a twelve-year period, beginning at 4%, increasing to 8% the next year, and then increasing at the rate of 2% per year until the current corporate capital gains rate of 28% is reached.¹⁸⁸ The phase-in proposed by the Staff Report would apply only to corporate long-term capital gains, including section 1231 gains treated as long-term capital gains. Thus, no relief would be available for ordinary income recognized by the corporation. Since the phase-in would eventually impose the present 28% corporate tax on capital gains, the phase-in would merely

184. *See id.* at 142 (statement of Robert A. Jacobs).

185. I.R.C. § 1222(3) (1982). *But see* Tax Reform Act of 1984, § 1001, 98 Stat. 494, 1011 (reducing holding period for long-term capital gain to six months for property acquired after June 22, 1984, and before Jan. 1, 1988).

186. I.R.C. § 1223(2) (1982).

187. STAFF REPORT, *supra* note 11, at 65-66, 94.

188. *Id.* at 66.

postpone, and not eliminate, the problem of double taxation of such gains. In view of the fact that the double tax would result in a maximum total tax on long-term capital gains of 42.4%, and considering the fact that a large portion of such gain may be inflation-created, the phase-in proposed in the Staff Report does not appear to be a proper response to the problem.

The development of a shareholder tax credit based on the corporate level tax paid on liquidating gain would provide a permanent solution to the double tax problem. Theoretically, Congress could base the shareholder credit on the corporate-level tax imposed on all of the corporation's liquidating gain. The ALI Proposals, however, suggest a shareholder credit based only on the corporate capital gain tax paid as a result of liquidation.¹⁸⁹ The ALI suggestion apparently reflects the determination that the double tax on liquidation is inappropriate only as to gains on long-held assets. The Staff Report rejects any shareholder tax credit proposal as too complicated,¹⁹⁰ a view shared by many practitioners.¹⁹¹

The argument favoring rejection of the shareholder credit because it is too complex deserves examination. Although, in the context of Subchapter C, complexity alone is not necessarily a valid reason for avoiding an approach to a particular problem, the shareholder tax credit would be complex. Much of the complexity in drafting and administering a shareholder tax credit arises in the context of nonliquidating distributions,¹⁹² but the credit would present some problems in the context of liquidating distributions as well. For example, rules would have to be drafted to deal with allocation of the credit to holders of preferred stock and convertible debt, and the shareholder credit could create inequities. The shareholder credit should not be permitted to exceed the shareholder's recognized gain on the liquidation. For that reason, a shareholder who has a high basis in his or her stock would realize a relatively small gain on liquidation and might be unable to utilize the credit fully, while a shareholder with a low basis in his or her stock would be able to take full advantage of the credit. In addition, if a shareholder is a tax-exempt entity, the credit would be worthless to the shareholder. Should such a shareholder nonetheless be allocated a share of the credit, and, if so, should such share be refundable so that the shareholder can use the credit? If the purpose of the shareholder credit is to avoid double taxation, the tax-exempt shareholder should be allocated a portion of the tax credit so that each shareholder will receive a portion equal to the amount of stock owned, but that credit should not be refundable. The shareholder tax credit should not be used to create a tax benefit for a shareholder not affected by double taxation.

A shareholder tax credit raises several additional questions. First, should the shareholder credit be based on any income recognized by the

189. ALI PROPOSALS, *supra* note 11, at 134-41 (Proposal C 3).

190. STAFF REPORT, *supra* note 11, at 93.

191. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 85, at 90 (statement of Edward N. Delaney); *id.* at 169 (statement of John S. Nolan); *id.* at 276-78 (statement of James M. Roche).

192. See *id.* at 276-78 (statement of James M. Roche).

liquidating corporation under any statutory recapture provisions, the tax benefit rule, or the assignment of income rules? If the recapture provisions are to be effective in dealing with excess depreciation taken by a corporation, the effect of the recapture should not be diluted by use of a shareholder credit based on recapture income. Similarly, if the tax benefit rule and the assignment of income rules are to be effective, the shareholder tax credit should not be based on income recognized under these rules.

Second, should the shareholder credit be based on the corporate-level tax on ordinary income, other than recapture income, recognized by the liquidating corporation? Basing the shareholder credit on such ordinary income potentially raises the collapsible corporation problem. While the corporation would be taxed on the ordinary income, the impact of the corporate-level tax would be reduced or eliminated by giving shareholders a credit based on ordinary income against the shareholder's capital gain. If a principal concern is that repeal of the liquidation nonrecognition provisions would impose a confiscatory rate of tax on gain created largely by inflation, the shareholder credit should limit relief to the corporate-level tax on such gain. Finally, permitting a shareholder credit based on the corporate-level tax on ordinary income would continue the existing disharmony between the tax treatment of an unincorporated proprietor's bulk sale of inventory and a corporation's liquidating bulk sale of inventory.

Third, should the shareholder credit be limited to a credit based on the corporate-level tax on long-held capital assets and section 1231 assets? As discussed earlier, if the concern is the excessive tax on inflation-created gains, merely limiting the shareholder credit to the corporate-level tax paid on long-term capital gain generated by the sale or distribution of capital assets and section 1231 assets may provide more protection than is required. Perhaps an appropriate solution would base the credit on the corporate-level tax paid on gain from long-held capital assets and section 1231 assets, since those assets would most likely carry inflation-created gain. Such an approach would, of course, involve the difficult question of defining the term "long-held."

A final point that requires review as part of an examination of possible action to mitigate the effects of repeal of the liquidation nonrecognition provisions is the proper treatment of the goodwill of a liquidating corporation. Although the Staff Report deals with goodwill in the context of corporate acquisitions,¹⁹³ it does not deal explicitly with goodwill in the context of corporate liquidations. The Staff Report generally treats corporate liquidations in the same way as corporate acquisitions are treated. If a corporation liquidates by selling its assets and distributing the proceeds of the sale, then presumably the Staff Report approach produces the result that, as in cost basis acquisition,¹⁹⁴ any unallocated acquisition premium attributable to goodwill would not be taxed at the corporate level. Presumably for the same reason, goodwill takes a carryover basis in the hands

193. STAFF REPORT, *supra* note 11, at 58, 61.

194. *Id.* at 60.

of the purchaser. The manner in which the Staff would deal with goodwill in the context of an in-kind liquidation, however, is not clear. Arguably, the proper result depends on whether the liquidation marked the termination of a business or the continuation of business in unincorporated form. If the business simply terminated, any goodwill associated with the business would be extinguished. If, however, the business were continued in unincorporated form, the goodwill would also continue. In such a situation the goodwill should not be taxed at the corporate level, but should take a carryover basis in the hands of the shareholders.

6. *A Possible Compromise*

No solution to the problems discussed in this Article will satisfy everyone. As the foregoing discussion indicates, the present liquidation nonrecognition provisions were not the product of careful analysis and they do produce significant problems. All of the proposed changes, however, raise significant problems of their own. For the reasons thoroughly discussed in Professor Alvin Warren's excellent article,¹⁹⁵ the best solution to the problems raised by the liquidation nonrecognition provisions is integration of the corporate and individual income taxes. Since Congress will not likely embrace integration, the corporate income tax will assumedly continue to exist as a separate tax, so any tax reform should be structured accordingly. If that assumption is correct, Congress must ask whether the liquidation nonrecognition provisions present a problem of sufficient magnitude to require some sort of change.

Arguably, some change is needed. The liquidation nonrecognition provisions, together with the liquidation basis provisions, do create an incentive for liquidation. That incentive exists because a taxpayer presently can utilize a liquidation to obtain a stepped-up basis in corporate assets at the cost of recognition of long-term capital gain at the shareholder level. Since this incentive is the real problem created by the liquidation nonrecognition provisions, complete repeal of these provisions is far too drastic a means of resolving the problem. The following approach seeks to eliminate the incentive, while recognizing that liquidations are undertaken for one of three reasons.

The existing liquidation nonrecognition provisions would be repealed and replaced by provisions that would carry out the following treatment of liquidations. Corporate asset sales that currently are covered by section 337, would, with the exception of sales of goodwill, be taxable events for the selling corporation. Purchasers of the corporate assets would take a cost basis in all assets except for goodwill, in which they would take a carryover basis. The shareholders of the liquidated corporation would be allowed a nonrefundable credit based on the amount of corporate capital gains tax paid. Liquidations involving in-kind distributions to shareholders would be subject to a corporate election. The liquidating corporation

195. Warren, *supra* note 87.

could elect to have the liquidation treated either as a taxable event for the corporation, or as a nonrecognition event, except to the extent of recapture of depreciation, recapturable tax credits, and recognition required by the tax benefit or the assignment of income rules. If the liquidation is treated as a taxable event for the corporation, shareholders would recognize gain under sections 331 or 1001, taking the corporate assets with a basis equal to the fair market value of the assets on the date of distribution and utilizing the nonrefundable tax credit mentioned above. If the liquidating corporation elects to avoid taxation at the corporate level, except for recapture gain, the corporate assets would be distributed to the shareholders with a carryover basis. Shifting of losses would be prevented by requiring the shareholders to compute loss based on the lesser of either the fair market value of the assets on the date of the liquidating distribution or the carryover basis. No tax credit would be allowed to the shareholders because no double taxation of corporate capital gain would be involved.

The approach set forth above poses several problems. First, the approach would make the sort of asset acquisitions now accomplished under section 337 less desirable than they presently are. Imposition of the corporate-level tax is, however, necessary in order to prevent a purchaser from taking the liquidating corporation's assets with a stepped-up basis, but without any corresponding tax on the appreciation in value of those assets. This approach would respond to the criticism that the present system encourages sales of businesses rather than the continuation and growth of businesses.¹⁹⁶ This approach might encourage use of tax-free reorganizations to accomplish sales of businesses, but acquiring corporations would not be able to step up the basis of the acquired corporation's assets without exposing the appreciation in the value of such assets to taxation.

Second, the approach would result in the deferral of gain recognition in many instances, and the value of such deferral can be a great benefit to a taxpayer. The deferral is, however, justified in the context of an in-kind liquidation that results in the continuation of a business in unincorporated form by the liquidated corporation's former shareholders. The rationale justifying deferral for such liquidations is the same rationale justifying deferral presently permitted under section 351 for newly incorporated businesses.

Third, in the case of in-kind liquidations that result in a business operating in unincorporated form, the existence of section 1014 allows the deferred gain to be eliminated entirely upon the death of a former shareholder. If, however, the opportunity for a step-up in basis at death is deemed to be a problem, that problem should be addressed as a separate issue.¹⁹⁷

196. See ALI PROPOSALS, *supra* note 11, at 112; Lewis, *supra* note 78, at 1647.

197. Deputy Assistant Secretary of the Treasury Pearlman suggested addressing this problem by denying such assets a § 1014 basis increase, but did not explain the mechanics of this solution. *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 17. Perhaps, borrowing from § 306, the proposed solution could be implemented by treating such assets

Finally, by distinguishing between asset sales and in-kind distributions, the approach would probably cause taxpayers to try structuring liquidations as in-kind distributions, followed closely by the sale of the distributed assets by the shareholders. To avoid revival of the *Court Holding—Cumberland Public Service* problem,¹⁹⁸ an asset holding period of perhaps one year would need to be imposed. If the shareholders sold the assets during that period, they would be responsible for paying a tax equal to the tax that the corporation would have paid on distribution of the assets if the liquidation had been treated as a taxable event for the distributing corporation. Such a holding period might result in a hardship to the shareholders in the event that unforeseen conditions made the sale of the business necessary during the one-year period. The hardship problem could be resolved, at least in part, by creating a rebuttable presumption that if a sale occurred during the holding period, the shareholders never intended to continue the business in the unincorporated form.

Notwithstanding the problems posed above, this suggested approach does address what arguably is the real evil created by the liquidation nonrecognition provisions: the opportunity to obtain a stepped-up asset basis without the imposition of any tax on the accrued appreciation in asset value. Those who advocate complete repeal of the liquidation nonrecognition provisions as a means of accomplishing the broad reforms discussed earlier in this Article will argue that anything less than complete repeal is not workable. Those who are willing to recognize that complete repeal could result in the creation of as many problems as it resolves will focus on dealing with the real evil created by the provisions.

V. CONCLUSION

The liquidation nonrecognition provisions have not, to this point, received proper congressional attention. Although these provisions can be criticized on many grounds, complete repeal of the liquidation nonrecognition provisions would work a profound change on our system of corporate taxation. Before making any changes to Subchapter C, Congress must identify the problems requiring resolution. The principal problem with the liquidation nonrecognition provisions is arguably neither complexity nor the opportunity to escape double taxation. Rather the real problem is that the liquidation nonrecognition provisions, in combination with the liquidation basis provisions, allow the purchaser or the distributee of a liquidating corporation's assets to obtain a stepped-up basis in those assets without the imposition of any corresponding tax on the accrued appreciation in those assets. New depreciation benefits, therefore, are generated without any corresponding obligation to pay tax. If Congress will focus on the real nature of the problems posed by the liquidation nonrecognition

as "tainted." The taint would follow the assets to prevent defeating the proposed solution by means of a gift of such assets. Such an approach could be difficult to administer.

198. See *supra* notes 177 & 178 and accompanying text.

provisions, fashioning a response that reflects both sound tax policy and economic and business reality should be possible.

Congress must approach consideration of this problem deliberately. No one would argue strenuously that the time has not come for a careful review of Subchapter C, to be followed by carefully crafted reform of the Subchapter. As the Staff Report notes, the fundamental principles of the Federal corporate income tax were being reexamined by Congress "for the first time in 50 years."¹⁹⁹ Nevertheless, in the rush to address the problems of Subchapter C, Congress should not succumb to pressure to take precipitate action. While the Senate Finance Committee Staff began studying the possible reform of Subchapter C shortly after October 28, 1982,²⁰⁰ the Staff Report and the unofficial draft legislation reflect the fact that the Staff does not yet have the legislative proposals in final form.²⁰¹ Further, although the American Law Institute has been working on its Subchapter C study since 1974,²⁰² the ALI Proposals reflect alternative courses of action with no definite recommendation as to the most desirable of the alternatives.²⁰³ Finally, comments on the Staff Report suggest that much work remains before reform legislation can be drafted and considered by Congress.²⁰⁴ For all of these reasons, Congress should approach the reform of Subchapter C with a willingness to spend the time needed to achieve a properly crafted legislative result. The recent experience with hastily drafted tax legislation²⁰⁵ presents a strong argument against moving too quickly.

199. STAFF REPORT, *supra* note 11, at 4.

200. See Statement of Sen. Robert Dole, Oct. 28, 1982, 17 TAX NOTES 494 (Nov. 8, 1982).

201. The portion of the Staff Report that deals with the repeal of the liquidation nonrecognition provisions recognizes that some relief from the effects of repeal is necessary. The Staff Report presents five options that might be used to give relief, but does not reach any conclusion as to which alternative is the most desirable. STAFF REPORT, *supra* note 11, at 93-94. The unofficial draft of proposed legislation has been characterized as "preliminary" and "not a complete piece." See Bernick, *Finance Writes Preliminary Language for Parts of Sub C Plan*, 22 TAX NOTES 77, 77 (Jan. 9, 1984).

202. ALI PROPOSALS, *supra* note 11, at 1.

203. *Id.* at 19-20, 104.

204. See *Finance Hearing on Reform of Corporate Tax*, *supra* note 87, at 17 (statement of Ronald A. Pearlman).

205. See Surrey, *Our Troubled Tax Policy: False Routes and Proper Paths to Change*, TAX NOTES SPECIAL STUDY 9 (1981); Pierson, *supra* note 165.